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In The

# Supreme Court of the United States

MEADWESTVACO CORPORATION,
successor in interest to THE MEAD CORPORATION,

*Petitioner,*

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

*Respondents.*

**On Petition For A Writ Of Certiorari To The Appellate Court Of Illinois**

## PETITION FOR A WRIT OF CERTIORARI


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## QUESTION PRESENTED

Is the attempt by Illinois to tax the approximately $1 billion gain realized by Petitioner when it sold its investment in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the decisions of the Court in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982) and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and the Due Process and Commerce Clauses of the United States Constitution?

## RULE 29.6 STATEMENT

Petitioner, The Mead Corporation, was a publicly held company with no parent company or publicly held company owning more than 10% of the Company's stock during the year ended December 31, 1994, the tax period involved in the dispute. As of January 29, 2002, MeadWestvaco Corporation was formed. From January 29, 2002 through December 31, 2002, MeadWestvaco Corporation functioned as a holding company with two assets – all of the stock of The Mead Corporation and all of the stock of Westvaco Corporation. On December 19, 2002, MW Custom Papers, Inc. was incorporated. On December 31, 2002, The Mead Corporation was merged into MW Custom Papers, Inc. Later on December 31, 2002 MW Custom Papers, Inc. was converted into MW Custom Papers, LLC. After this conversion, the majority of the operations and assets previously owned by The Mead Corporation and then contained within MW Custom Papers, LLC were transferred to MeadWestvaco Corporation. MeadWestvaco Corporation is the successor in interest to The Mead Corporation. MeadWestvaco Corporation is a publicly held company with no parent company or publicly held company owning more than 10% of MeadWestvaco Corporation's stock.

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## PETITION FOR A WRIT OF CERTIORARI

Petitioner respectfully seeks this Court's review of the January 12, 2007 opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division and the January 24, 2007 Denial of the Supreme Court of Illinois of the Petition for Leave to Appeal.

## OPINIONS BELOW

The Denial of the Supreme Court of Illinois of the Petition for Leave to Appeal (Petition Appendix ("App.") 41a), dated January 24, 2007, is reported at 862 N.E.2d 235. The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division (App. 1a-22a), dated January 12, 2007, is reported at 861 N.E.2d 1131. The order of the Appellate Court of Illinois, First Judicial District, granting the Respondents' motion to publish a Rule 23 order as a precedential decision and withdrawing the Rule 23 order issued on November 3, 2006 (App. 23a-24a), dated January 3, 2007, is not reported. The Memorandum Decision, Judgment and Order of the Circuit Court of Cook County, Illinois (App. 28a-40a) filed on March 18, 2003, is not reported. The Final Judgment Order of the Circuit Court of Cook County, Illinois (App. 25a-27a) entered on March 25, 2003, was not reported.

## JURISDICTION

The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division (App. 1a-22a), was rendered on January 12, 2007. The Denial of the Supreme Court of Illinois of the Petition for Leave to Appeal (App.

41a), was issued on January 24, 2007. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

## CONSTITUTIONAL PROVISIONS INVOLVED

The United States Constitution provides: "The Congress shall have the Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3 (the Commerce Clause).

The Fourteenth Amendment to the United States Constitution provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1 (the Due Process Clause).

## INTRODUCTION

This Petition presents the question whether Illinois can violate the principles set forth in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982) and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and the Due Process and Commerce Clauses of the United States Constitution, by ignoring the factors articulated by this Court in determining whether an asset serves an operational function such that income from the sale of that asset can be subjected to tax by a non-domiciliary state. Furthermore, and again in direct contravention of the principles articulated by this Court, the factors relied upon

by Illinois in reaching its determination would almost always in today's business world lead to a conclusion that an operational relationship exists where one business owns another. Consequently, if the Illinois decision is allowed to stand it will eviscerate the operational test articulated by this Court and result in virtually all income being subject to apportionment.

Petitioner acquired Data Corporation, which became Mead Data Central, in 1968 for $6 million. One of the technologies included in this acquisition was an experimental full-text information retrieval technology which, for the first time, applied computers to legal research and eventually became the Lexis/Nexis information service (this business will be referred to as "Lexis/Nexis").

Petitioner was, and is, in the business of producing and selling forest products, including paper and school supplies. Lexis/Nexis was in the electronic publishing business.

Lexis/Nexis did not receive its big break until the 1970s when this Court became a customer, leading to courts at every level becoming customers, which inevitably led to law firms, law schools and the entire legal profession becoming customers. Lexis/Nexis grew from a small legal database into the world's premier provider of online legal information.

The controversy in this matter stems from Petitioner's gain from the liquidation of its investment in this completely separate business, Lexis/Nexis, in 1994 (the "gain") and Respondents' taxation of the gain. It is Petitioner's position that, as a non-domiciliary of Illinois, Illinois cannot tax the gain because Petitioner's

investment in Lexis/Nexis served an investment as opposed to an operational function in accordance with this Court's decisions in *Allied-Signal*, *Woolworth* and *ASARCO*.

As concluded by the trial court, Lexis/Nexis did not engage in a unitary business with Petitioner. Specifically, the trial court found that Petitioner and Lexis/Nexis "were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses." App. 39a. Despite the fact that Petitioner and Lexis/Nexis were in two distinct businesses, the trial court went on to find, and the appellate court concurred, without foundation, that Petitioner's investment in Lexis/Nexis served an operational rather than investment function.

The factors relied upon by the appellate court as indicative of Lexis/Nexis serving Petitioner in an operational rather than investment function start with the fact that Petitioner owned 100% of Lexis/Nexis. However, this Court has held that income received by a non-domiciliary corporation from wholly owned subsidiaries was not apportionable to New Mexico where there did not exist a unitary relationship between the parent and the subsidiaries. *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 370 (1982).

The remainder of the factors relied upon by the appellate court all stem from this first factor, *i.e.*, the remaining factors all reflect an ordinary relationship between a company and a 100% owned business. Such factors were: (1) Petitioner's capital investment in the early years of Lexis/Nexis; (2) Petitioner's receipt of the

benefit of certain tax advantages; (3) Petitioner's investment of Lexis/Nexis' excess cash (for the benefit of Lexis/Nexis); (4) Petitioner's approval of major debt and major capital expenditures; (5) Petitioner's ability to change Lexis/Nexis from a division to a subsidiary; and (6) Petitioner's inclusion of Lexis/Nexis in describing the company's business in its annual reports and Forms 10-K.

These factors, however, exist in virtually every situation where one business owns another. If allowed to stand, reliance by Illinois on these factors would render this Court's holding setting forth the operational requirement in *Allied-Signal* meaningless. It would mean that all income received by non-domiciliary corporations from subsidiaries or divisions would be subject to apportionment. This is precisely what New Jersey argued for in *Allied-Signal*. This Court responded that the unitary business principle has existed since the beginning of the twentieth century, that it is workable in practice, and that to overrule it at this late date would make it unworkable in practice. Illinois cannot be allowed to circumvent this Court's holding in *Allied-Signal*.

## STATEMENT OF THE CASE

As the appellate court recognized, the facts in this matter are "essentially undisputed." App. 2a.

### A. Petitioner's Business

At all times relevant hereto, Petitioner was a corporation incorporated under the laws of Ohio that maintained its commercial domicile in Dayton, Ohio.

Petitioner was, and is, in the business of producing and selling forest products, including paper, packaging and school and office supplies.

In 1968, Petitioner acquired Data Corporation because it was interested in its ink jet printing technology. Data Corporation also had two other technologies, one of which was a full-text experimental information retrieval technology which was the predecessor of Lexis/Nexis. Lexis/Nexis developed the information retrieval technology, in a project with the Ohio and Missouri Bar Associations, into a service that would assist in researching law. This project lasted until 1972, when it was decided to develop this service on a national basis. Lexis was launched in 1973.

Lexis/Nexis received a big break in the 1970s when this Court became a customer. Courts at every level soon became customers, which inevitably led to law firms, law schools and the rest of the profession becoming customers. Nexis, a news and information service aimed at the financial market, was launched in approximately 1980.

Lexis/Nexis had its own building in Miamisburg, Ohio. Petitioner was located at its corporate headquarters in downtown Dayton, Ohio. Lexis/Nexis maintained its own facilities that were separate from the facilities maintained by Petitioner. There were no shared facilities between Petitioner and Lexis/Nexis.

Lexis/Nexis was responsible for all of its own personnel matters. Bonuses for Lexis/Nexis personnel were based upon the performance of Lexis/Nexis measured against its business plan. There were many years when Lexis/Nexis employees received bonuses while Petitioner's employees did not.

There were no shared departments between Petitioner and Lexis/Nexis. For example, Lexis/Nexis maintained the following departments, all of which were separate from Petitioner: accounting; internal audit; internal legal; credit and collection; human resources; real estate; purchasing; and marketing.

While Lexis/Nexis could have invested its own excess funds, Petitioner invested cash for Lexis/Nexis. However, the funds and the investment returned on those funds accrued specifically to Lexis/Nexis.

Petitioner exercised very little control over the capital acquisitions of Lexis/Nexis. Lexis/Nexis made its own purchases based upon its business plan. As would any investor in a company, Petitioner's board of directors reviewed and approved major capital expenditures by Lexis/Nexis, changes to Lexis/Nexis' legal structure and other large, nonrecurring transactions. Petitioner also made some capital contributions to Lexis/Nexis.

While the legal relationship between Petitioner and Lexis/Nexis changed several times between a division and a subsidiary, this did not affect the operations of Lexis/Nexis. Indeed, most people at Lexis/Nexis were not even aware of any changes.

To Petitioner, Lexis/Nexis was simply an investment. Petitioner therefore let the company run itself. Once a year, Lexis/Nexis management would present a business plan to Petitioner and that was the extent of Petitioner's involvement in the operations of Lexis/Nexis.

The Illinois Department of Revenue's auditor conceded that Petitioner and Lexis/Nexis were not in the same line of business or vertically integrated. Furthermore, he conceded

that there was no functional integration between Petitioner and Lexis/Nexis, *nor was there any operational relationship between the businesses.* Simply stated, Illinois' own auditor acknowledged that Petitioner was a passive investor in Lexis/Nexis.

On December 2, 1994, Petitioner announced the completion of the sale of Lexis/Nexis for approximately $1.5 billion. Petitioner is contesting the actions of Illinois in seeking to tax the $1,056,001,948.00 gain from that sale reported by Petitioner as nonapportionable income on its Illinois return for the tax year 1994.

## B. Proceedings Below

The Illinois Department of Revenue issued two notices of deficiency to Petitioner asserting that, among other issues that are not the subject of this Petition, Petitioner was to apportion the gain from the sale of Lexis/Nexis to Illinois. Petitioner filed this action in the Circuit Court of Cook County Illinois asserting, as relevant to this Petition, that Petitioner did not have a unitary relationship with Lexis/Nexis, nor did Petitioner's investment in and disposition of Lexis/Nexis serve an operational, as opposed to an investment, function.

During the trial before the Circuit Court of Cook County, several expert witnesses in tax policy and one expert witness in economics testified and submitted their reports detailing their findings. Professor Walter Hellerstein, renowned in the state and local tax community, testified and provided a report as an expert witness in state tax policy. App. 48a-58a. With regard to any operational relationship that might have existed

between Petitioner and Lexis/Nexis, Professor Hellerstein opined in his report:

> In summary, because the relationship between Mead and MDC involved no meaningful functional integration, centralized management, or economies of scale; because there was no significant flow of value between Mead and MDC; and because neither Mead nor MDC served an operational function in each other's business, Illinois lacks the power to include the gain that Mead (a nondomiciliary corporation) earned from its disposition of MDC.

App. 57a. (Mead being Petitioner and MDC being Lexis/Nexis.)

Professor Richard D. Pomp, also renowned in the state and local tax community, testified and provided a report as an expert witness in state tax policy. App. 59a-77a. With regard to any operational relationship that might have existed between Petitioner and Lexis/Nexis, Professor Pomp opined in his report:

> Based upon the above facts and applying the governing principles of state tax policy, my opinion is that Mead and Lexis/Nexis were separate businesses. Lexis/Nexis did not contribute to Mead's unitary paper business, nor was Mead's unitary paper business dependent upon Lexis/Nexis. Accordingly, I conclude that from a policy prospective, Lexis/Nexis is not part of Mead's unitary paper business so that for that reason no nexus exists between Illinois and the gain on the liquidation of Mead's ownership of

> Lexis/Nexis to justify the Department's apportionment of the gain.

App. 71a. (Mead being Petitioner.)

Professor Ferdinand P. Schoettle, also renowned in the state and local tax community, testified and provided a report as an expert witness in economics. App. 78a-103a. With regard to any operational relationship that might have existed between Petitioner and Lexis/Nexis, Professor Schoettle opined in his report:

> As to the relationship between Mead and Lexis-Nexis, based upon my investigations I concluded that operational integration between Mead and Lexis-Nexis was virtually zero. Mead kept Lexis-Nexis as a separate business, an investment in a very different business than its own. That separateness was the reason Mead sold Lexis-Nexis. Mead had neither publishing nor computer expertise nor any other line function which it could integrate with Lexis-Nexis. Given these conditions, Lexis-Nexis was truly a "stand alone" company.

App. 93a. (Mead being Petitioner.)

The Circuit Court of Cook County found that Petitioner and Lexis/Nexis "were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses." App. 39a. Based upon those findings the Circuit Court of Cook County concluded that, as a matter of law, Mead and Lexis/Nexis were not unitary. App. 39a. The Circuit Court of Cook County then found that the gain from Petitioner's sale of Lexis/Nexis was apportionable by

the State of Illinois because "Mead's investment in Lexis/Nexis did serve an operational purpose." App. 38a. Petitioner then filed an appeal with the Appellate Court of Illinois, First Judicial District, seeking reversal of the determination of the Circuit Court of Cook County.

The Appellate Court of Illinois, First Judicial District, concluded that Lexis/Nexis served an operational function for Petitioner.[1] App. 11a.

The Appellate Court of Illinois, First Judicial District, originally set forth these conclusions in an unpublished, non-precedential Rule 23 Order. Respondents then filed a Motion to Publish Rule 23 Order as Precedential Decision on November 14, 2006. App. 42a-47a. In this motion Respondents urged the Court to consider the importance of its decision as follows:

> *The decision provides such crucial guidance on a recurring issue* because it sets forth specific factors – such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits and control of excess cash – on which the Department, courts and taxpayers can rely in determining when a business unit qualifies as an operational asset and thus when the gain realized from its sale is constitutionally apportionable. *In addition, the decision is significant* because it approved of specific evidence on which the Department and courts can rely in making this determination – such as annual reports and federal 10-K statements – and disapproved of other evidence – the testimony of

[1] It did "not address the Department's claim of error as to the [Circuit Court's] 'lack of unitary business' finding." App. 11a.

> experts who offer opinions on matters of law – in deciding whether a business asset serves an operational function.

App. 45a (emphasis added).

Petitioner filed a Petition for Leave to Appeal with the Supreme Court of Illinois on December 8, 2006 with regard to the Appellate Court, First Judicial District's unpublished, non-precedential Rule 23 Order. The opinion of the Appellate Court of Illinois, First Judicial District (the precedential opinion issued in response to Respondent's motion), was issued on January 12, 2007 ("Illinois Decision"). App. 1a-22a. The Petition for Leave to Appeal was denied by the Supreme Court of Illinois on January 24, 2007. App. 41a.

## REASONS FOR GRANTING THE PETITION

### I. WITHOUT FURTHER REVIEW, THE ILLINOIS DECISION WILL EFFECTIVELY OVERTURN THE OPERATIONAL TEST SET FORTH IN *ALLIED-SIGNAL*

In *Allied-Signal* this Court held that even if two businesses operate on a non-unitary basis, a non-domiciliary state may still apportion the income from the disposal of one business if that business served an operational rather than an investment function. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992). Furthermore, this Court discussed the differences between an asset with an operational purpose and an asset with an investment purpose. The focal point of this Court's analysis for the finding of an operational relationship has been whether the asset was utilized

directly in the selling company's business, or was utilized as a short-term investment to fund the day-to-day operations of the selling company.

In this case, the trial court held that Petitioner and Lexis/Nexis were *not* unitary. Then, contrary to this Court's precedent, and without foundation, the trial court held and the appellate court affirmed the finding that Petitioner's investment in Lexis/Nexis was "operational."

The inquiry should not have ended with a determination that Lexis/Nexis was 100% owned by Petitioner nor should it have considered the other factors directly flowing from the 100% ownership (*i.e.*, Petitioner's capital investment in the early years of Lexis/Nexis, Petitioner's receipt of the benefit of certain tax advantages, Petitioner's investment of Lexis/Nexis' excess cash (for the benefit of Lexis/Nexis), Petitioner's approval of major debt and major capital expenditures, Petitioner's ability to change Lexis/Nexis from a division to a subsidiary and Petitioner's inclusion of Lexis/Nexis in describing the company's business in annual reports and Forms 10-K). Not only has this Court never even implied that any of these factors are to be considered in reaching a determination on the operational nature of an asset, but this Court has held that many of these factors are not indicative of whether a certain item of income may be apportioned to a non-domiciliary state.

The Illinois Decision improperly points to the fact that Petitioner owned 100% of Lexis/Nexis. In *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354, 356-57 (1982), however, this Court found that Woolworth and its subsidiaries were not part of a unitary business, even where three of the subsidiaries were wholly

owned. Moreover, in the context of a unitary business and in finding that the income received by Woolworth from the subsidiaries was not apportionable, the Court held that the mere potential to operate a subsidiary as part of a unitary business is insufficient for allowing the apportionment of income by a non-domiciliary state. *Id.* at 362 ("the *potential* to operate a company as part of a unitary business is not dispositive when, looking at 'the "underlying economic realities of a unitary business,'" the dividend income from the subsidiaries *in fact* is '[derived] from "unrelated business activity" which constitutes a "discrete business enterprise"'" (citations omitted)); *see also ASARCO Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 323 (1982) ("Although ASARCO has the control potential to manage [the subsidiary], no claim is made that it has done so.").

The Illinois Decision improperly points to Petitioner's capital investment in the early years of Lexis/Nexis. *Woolworth*, 458 U.S. at 366 n.14 (where previous capital contributions did not lead to the apportionment of income by New Mexico).

The Illinois Decision also points to Petitioner's receipt of certain tax advantages, Petitioner's investment of Lexis/Nexis' excess cash (for the benefit of Lexis/Nexis), Petitioner's ability to change Lexis/Nexis from a division to a subsidiary and Petitioner's inclusion of Lexis/Nexis in describing the company's business in annual reports and Forms 10-K as bases for finding an operational relationship. These factors, however, will be present in any relationship between a parent company and a 100% owned business. Therefore the inescapable result of the Illinois Decision is that in Illinois, and in any other state that

decides to follow the holding, the operational requirement of *Allied-Signal* no longer exists.

Furthermore, this Court has held that for the continued vitality of the unitary principle, it cannot be that all income earned by a corporation is apportionable income:

> [t]he business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the [corporation's] business."

*ASARCO,* 458 U.S. at 326 (emphasis and citation omitted).

To allow the Illinois Decision to stand would be a violation of this principle in that in every situation where a parent owned 100% of a subsidiary or a division, all income from that business would be classified as apportionable income, regardless of the factual circumstances.

With regard to Petitioner's investment of excess cash on behalf of Lexis/Nexis, this Court in *Woolworth* noted that considering this commingling of funds to be determinative of the issue of the existence of a unitary relationship "subverts the unitary-business limitation. *All* dividend income – irrespective of whether it is generated by a 'discrete business enterprise,' – would become part of a unitary business if the test were whether the corporation commingled dividends from other corporations, whether subsidiaries or not." 458 U.S. at 364 n.11 (citation omitted). Furthermore, with regard to all of these issues this Court noted that consolidated accounting and

consolidated statements did not lead to a conclusion that [illegible]ted a unitary relationship. *Id.* at 369 n.22. *See also Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992) (in holding that a gain was not apportionable, this Court ignored descriptions of business activities in annual reports that the Supreme Court of New Jersey had relied upon in reaching the opposite conclusion).

The Illinois Decision also relied upon the fact that Petitioner continued to approve major capital expenditures. This action, however, amounts to nothing more than actions any good investor would take with regard to an investment. *Woolworth*, 458 U.S. at 369 (in concluding a unitary business did not exist the Court found that "[e]xcept for the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management").

The Illinois Decision did not address the two determinative focal points of this Court's previous discussions of the operational test – whether the asset was utilized directly in the selling company's business, or whether the asset was utilized as a short-term investment to fund the day-to-day operations of the selling company. *E.g.*, *Allied-Signal,* 504 U.S. at 789-90 ("Nor can it be maintained that Bendix's shares of ASARCO stock, which it held for over two years, amounted to a short-term investment of working capital analogous to a bank account or certificate of deposit."); *Corn Prods. Refining Co. v. Commissioner*, 350 U.S. 46, 50 (1955) (corn futures were vitally important to a corn products business as a guarantee against increases in the prices of raw corn).

Several other cases discuss an operational versus investment function in the context of determining the apportionability of income to a non-domiciliary state. The focus of all of these discussions is whether the asset was used in the same line of business as the company that sold it or whether the asset was analogous to working capital. None of the factors relied upon in the Illinois Decision are factors to be considered in deciding whether an asset serves an operational or investment function. *See Woolworth*, 458 U.S. at 370 ("In this case the parent company's operations are not interrelated with those of its subsidiaries so that one's 'stable' operation is important to the other's 'full utilization' of capacity." (citations omitted)); *Allied-Signal*, 504 U.S. at 789 (explains the holding in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) by saying that a unitary relationship is shown where the management role of the parent "is grounded in its own operational expertise and operational strategy").

Petitioner's ownership of Lexis/Nexis, which lasted almost 26 years, served an investment function. Lexis/Nexis was acquired as an investment, and its management was separate from Petitioner's. Like Bendix's ownership of ASARCO, Petitioner's ownership of Lexis/Nexis did not amount to "a short-term investment of working capital." *Allied-Signal,* 504 U.S. at 790. Furthermore, unlike the facts in *Container Corp.* and *Corn Products*, Petitioner and Lexis/Nexis were in two completely separate and independent lines of business.

As noted by Illinois in its Motion to Publish Rule 23 Order as Precedential Decision before the Appellate Court of Illinois:

> The decision provides such crucial guidance on a recurring issue because it sets forth specific factors – such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits and control of excess cash – on which the Department, courts and taxpayers can rely in determining when a business unit qualifies as an operational asset and thus when the gain realized from its sale is constitutionally apportionable. In addition, the decision is significant because it approved of specific evidence on which the Department and courts can rely in making this determination – such as annual reports and federal 10-K statements – and disapproved of other evidence – the testimony of experts who offer opinions on matters of law – in deciding whether a business asset serves an operational function.

App. 45a.

Petitioner could not agree more that this incorrect decision will have a major effect on tax administration not only in Illinois, but in every state. The detrimental effect of this decision will impact every multi-state taxpayer. This Court's intervention is required to ensure that multi-state taxpayers and state taxing authorities alike receive a correct and uniform analysis in the determination of whether an asset serves an operational function or an investment function.

To let the Illinois Decision stand would be to decide that in any situation where a non-domiciliary business owns 100% of a subsidiary or division, all income from such subsidiary or division is apportionable by Illinois. This

would render the operational requirement of *Allied-Signal* meaningless.

## II. WITHOUT FURTHER REVIEW, THE ILLINOIS DECISION, WHICH DECIDES AN IMPORTANT FEDERAL QUESTION, WILL STAND IN CONFLICT WITH DECISIONS OF OTHER STATE COURTS OF LAST RESORT

The Supreme Court of Minnesota dealt with the issue of whether an asset served an operational or investment function as follows:

> *Allied-Signal* stated that an assessment of whether an intangible asset served an operational function must focus "on the objective characteristics of the asset's use and its relation to the taxpayer and its activities in the taxing state." The Court gave us two examples of how an intangible might serve an operational function: a short term investment analogous to a bank account or certificate of deposit, or, under its decision in *Corn Products Refining Co. v. Commissioner*, a long-term investment in commodity futures that ensures a certain supply of a necessary product at a fixed price.
>
> As we discussed above, however, there is no evidence that Hercules treated its investment in Himont as a repository for working capital like a bank account or certificate of deposit. Nor did Hercules hold its Himont stock as a hedge against a fluctuating supply of polypropylene.

*Hercules Inc. v. Commissioner of Revenue*, 575 N.W.2d 111, 117 (Minn. 1998) (citations omitted).

The state's highest court in Maryland, the Court of Appeals, reached the same conclusion based upon a similar analysis in a case involving the same taxpayer and the gain from the sale of the same intangible asset. *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276 (Md. 1998).

Neither of the courts of last resort in Minnesota or Maryland relied upon any of the factors relied upon in the Illinois Decision. While the Illinois Decision focuses solely on the potential control (*i.e.*, the 100% ownership of Lexis/Nexis by Petitioner and the factors flowing from such ownership) to support the conclusion that Lexis/Nexis served an operational function for Petitioner, the Court of Appeals of Maryland specifically rejected an argument made by the state regarding ownership and explained that pursuant to *Woolworth* the test for apportionability of the gain "was not the *potential* of unitary control, but rather the actual, in fact unitariness or separateness of the subsidiary enterprises." *Hercules*, 716 A.2d at 281. The Illinois Decision is in direct conflict with the decision of the Court of Appeals of Maryland in *Hercules*.

The Supreme Court of Alaska in *Alaska Department of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399 (Alaska 1998), reviewed the conclusion of a hearing officer that an asset had served an operational function. The hearing officer had based that conclusion on his finding (for which he relied heavily upon the statements in the company's annual reports) that the company's "'investment decisions were obviously aimed at building its financial strength overall.'" *Id.* at 413-14. The Supreme Court of Alaska found that "the hearing officer's definition of 'operational income' would swallow the distinction between operational

and investment income," in that all business decisions are made with the goal of profitability. *Id.* at 414. Indeed, the court noted that this Court had specifically rejected New Jersey's argument in *Allied-Signal* that any distinction between operational and investment income was artificial. *Id.* The Supreme Court of Alaska reversed the determination of the hearing officer, but remanded the matter for further proceedings with the instructions that the income from the asset could be apportioned by Alaska only if the asset were part of the company's unitary business, or the asset was a short term investment used to fund the day-to-day operations of the company that was similar to a bank account. *Id.* Again, the Illinois Decision, relying upon factors such as Petitioner's capital investment in Lexis/Nexis, its receipts of certain tax advantages, its approval of major debt and capital expenditures and the inclusion of Lexis/Nexis in its annual reports and Forms 10-K, is in direct conflict with this decision of the Supreme Court of Alaska.

Several other state courts of last resort have reached decisions similar to those of Alaska, Maryland and Minnesota. *Pennzoil Co. v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001) (In finding an operational relationship the Supreme Court of Oregon found: "The acquisition of oil reserves is related – indeed it is vitally important – to the continued blending and distribution of motor oil in Oregon."), *cert. denied*, 535 U.S. 927 (2002); *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 345 (Cal.) (In finding a pension plan and trust used to retain employees and attract new employees was related operationally to the taxpayer's business the Supreme Court of California stated: "Although the United States Supreme Court has not clearly differentiated operational

and investment functions, it has stated that an asset serves an operational function if it helps the taxpayer 'make better use . . . of [its] existing business-related resources.'" (citation omitted)), *cert. denied*, 534 U.S. 1040 (2001).

Thus the state courts of last resort that have dealt with the issue of determining whether an asset served an operational or investment function, have asked the questions – is the asset directly related to the business of the company that disposed of the asset, or is the asset a short-term investment similar to working capital. These questions are consistent with the decisions of this Court. Illinois now seeks to ignore these factors and to, instead, focus on other factors, most of which are not recognized as relevant to a determination of whether or not income is apportionable.

The Illinois Decision is in direct conflict with the decisions of the courts of last resort of other states and, if allowed to stand, will have a major effect on tax administration not only in Illinois, but in every state that imposes an income tax. This Court's intervention is required to ensure that multi-state taxpayers and state taxing authorities alike receive a correct and uniform analysis in the determination of whether an asset serves an operational or investment function.

## CONCLUSION

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Dated: April 20, 2007

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## APPENDIX A

**SIXTH DIVISION January 12, 2007**

No. 1-03-1160

| | |
|---|---|
| THE MEAD CORPORATION, an Ohio Corporation, Plaintiff-Appellant, | ) Appeal from the ) Circuit Court of ) Cook County |
| v. | ) |
| THE DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois, Defendants-Appellees. | ) No. 00 CH 7854 ) Honorable ) Alexander P. White, ) Judge Presiding. |

PRESIDING JUSTICE FITZGERALD SMITH delivered the opinion of the court:

Plaintiff Mead Corporation, an Ohio corporation (Mead or plaintiff), appeals three orders of the circuit court concerning the classification and calculation of sales gain reported on its 1994 Illinois tax return, granting judgment in favor of defendants Illinois Department of Revenue (Department), Glen L. Bower, Director of the Illinois Department of Revenue,[1] and Judith Baar Topinka, Treasurer of the State of Illinois (collectively, defendants). Mead filed a combined unitary Illinois income tax return for the 1994 tax year, including Mead Data Central, Inc., Lexis, Inc., and Nexis, Inc. (collectively, Lexis/Nexis), as members of its unitary business group, and including in

[1] Defendants note that the current Director, Brian Hamer, may be substituted for Bower, who is the former Director.

its Illinois combined apportionable business income the 1994 income earned by Lexis/Nexis, but excluding the gain of more than $1 billion from the sale of Lexis/Nexis that year. Mead also included its gross receipts from the sale of interest-bearing financial instruments in its sales factor denominator of the combined apportionment formula. The Department determined that the Lexis/Nexis sale gain constituted apportionable business income and the net income, rather than the gross receipts from the sale of the financial instruments, be used to compute Mead's sales factor denominator. After the Department issued notices of deficiencies for more than $4 million in income tax and interest, which Mead paid under protest, Mead challenged the Department's classification of the sales gain as apportionable business income and its calculation of the sales factor denominator. We affirm.

This case presents a voluminous record. However, the facts, as set forth below, are essentially undisputed.

Mead is an Ohio corporation which transacts business in Illinois. In 1968, when Mead was a producer and seller of paper, packaging, and school and office supplies, it purchased Data Corporation for $6 million. At the time, Data Corporation was developing, among other things, ink jet printing technologies and a computerized full text information retrieval system. The latter, by 1973, evolved into Lexis/Nexis. Over the years, Mead made capital contributions to Lexis/Nexis, which become profitable only by the end of the 1970s.

During its ownership of Lexis/Nexis, Mead treated Lexis/Nexis variously as a corporate division or as a subsidiary. In 1980, Lexis/Nexis was merged into Mead as a division; in 1985, Lexis/Nexis was reincorporated separately. In

December 1993, Mead and Lexis/Nexis merged again, with Lexis/Nexis again becoming a division of the parent company. During the years of ownership, Mead continued to approve major capital expenditures for Lexis/Nexis, including a 1984 expansion of the Lexis/Nexis computer center and central processing units. In 1993, at the time of the second merger, Mead's board of directors approved a capital expenditure of nearly $13 million for the improvement of Lexis/Nexis' search system. Again, the following year, the Mead board approved significant expenditures for Lexis/Nexis.

Mead and Lexis/Nexis maintained separate day-to-day business operations, and they did not share personnel or make joint purchases. Since 1980, Lexis/Nexis had its own building about 15 miles from Mead's Dayton headquarters. There was no centralized manufacturing or warehousing of products, and Mead and Lexis/Nexis were described as having different corporate cultures. There were no favorable intercompany transactions. However, Mead made nightly a cash sweep of Lexis/Nexis bank accounts, investing the funds with benefits accruing to Lexis/Nexis, but in a manner decided by Mead.

Since 1988, the Department had asserted that Mead and Lexis/Nexis were a unitary business. Although Mead disagreed, to settle disputed audit findings, Mead included Lexis/Nexis in its unitary business group from 1988 through 1994. According to Mead's 1993 annual report, Mead was not only "one of the world's largest manufacturers of paper," and a leader in packaging, but it was "the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information." Lexis/Nexis was included as one of Mead's business segments, but not in Mead's

discussion of its "investees." Mead filed a 10-K form with the Securities and Exchange Commission (SEC) for the year ending December 31, 1993, in which Mead described itself as a company engaged in the manufacture and sale of paper and wood products, and school and office supplies, and engaged in electronic publishing.

In May 1994, Mead announced its plan to sell Lexis/Nexis, stating in its press release that it had "grown" Lexis/Nexis "since 1968 from a small legal database into the world's premier provider of online legal information and the pioneer in computer-assisted news retrieval." On December 2, 1994, Mead sold the assets of Lexis/Nexis to Reed Elsevier, plc, for approximately $1.5 billion. In describing the divestiture in its 1994 annual report, Mead again stated that had "grow[n] this business" but decided to use approximately $350,000 of the gain to buy back stock. Mead also used the proceeds to reduce its short- and long-term debt levels.

For the 1994 tax year, Mead and its subsidiaries filed an Illinois combined unitary income tax return, in which it listed Lexis/Nexis as a unitary subsidiary, as it had done from 1988-93. Mead reported its base income as $1,074,709,139 and its Illinois sales in 1994 as $338,309,666, of which Lexis/Nexis contributed $46,912,518. Mead reported as nonbusiness income $1,056,001,948 in gain from the sale of its Lexis/Nexis division. The reported nonbusiness income was a gain on "goodwill" realized from the Lexis/Nexis sale. Mead also included Lexis/Nexis' assets in its Illinois apportionment factors on its 1994 Illinois return. Mead included in its computation of the denominator of the sales apportionment factor $4,846,382,229 as gross receipts from the sale of financial instruments, of

which $1,967,953.61 was interest income earned by those investments.

The Department audited Mead's Illinois income tax returns for the 1993 and 1994 tax years and issued two notices of deficiencies for the 1994 tax year. The deficiency notices resulted from two audit findings: (1) the $1,056,001,948 gain from the Lexis/Nexis sale was improperly classified as nonbusiness income and (2) Mead could include only the $1,967,953.61 that was interest income in its sales factor denominator rather than the $4,846,382,229 gross receipts from the sale of financial instruments. The Department found that Mead owed $3,149,222 in Illinois income tax and $1,049,017 in interest.

Mead protested, but paid the amount into the protest fund (see 30 ILCS 230/1 *et seq.* (West 2002)). In January 2001, Mead filed an amended verified complaint, seeking injunctive and declaratory relief. In the amended complaint, Mead challenged the Department's classification of the gain from the Lexis/Nexis sale as apportionable business income and the Department's calculation of its sales factor denominator.

In March 2002, proceedings on the former issue, which included the testimony of numerous witnesses, were held before the circuit court, while the latter issue was decided on the parties' cross-motions for partial summary judgment. As to the latter issue, the computation of the sales factor, the circuit court initially granted Mead's motion, and the Department filed a motion for reconsideration. On December 2, 2002, the court issued a memorandum decision, judgment and order, reversing the partial summary judgment in Mead's favor, denying

Mead's motion for partial summary judgment, and granting the Department's motion for the same.

On March 18, 2003, the court issued a memorandum decision, judgment and order deciding the classification issue. In its order, the court found, among other things, that Mead and Lexis/Nexis were not unitary, the sale of Lexis/Nexis represented a liquidation in the business of electronic publishing, and, because the property disposed of in the liquidation was "essential to the taxpayer's regular trade or operations," the gain therefrom was apportionable business income.

On March 25, 2003, the court issued a final judgment order, finding that all issues in plaintiff's first amended verified complaint had been resolved in favor of defendants (based on the findings of fact and conclusions of law set forth in the orders of December 2, 2002, and March 18, 2003) and that no remand to the Department was necessary. The court dissolved preliminary injunctions that had been entered in 1999 and 2001, ordered judgment to be entered in defendants' favor in the amount of $4,238,221, representing the 1999 and 2000 payments by plaintiff made under protest, ordered the State Treasurer to transfer the protest payments from the protest fund to the appropriate state fund, and stated that the order represented a complete disposition of all issues.

Mead appeals from the December 2, 2002, and March 18 and 25, 2003, orders.

On appeal, Mead first contends that the gain from the 1994 sale of Lexis/Nexis should be allocated rather than classified as apportionable Illinois income.

Initially, we note that the parties appear to agree on the standard of review. Both agree that the circuit court heard substantial testimony and considered documents and stipulated facts, but that, for the most part, the facts of this case were undisputed. The parties further recognize that, where the fact finder examines the legal effect of a given set of facts, it decides a mixed question of law and fact which is subject to an intermediate standard of review. See *Carpetland U.S.A., Inc. v. Illinois Department of Employment Security,* 201 Ill. 2d 351, 369, 776 N.E.2d 166 (2002); *City of Belvidere v. Illinois State Labor Relations Board,* 181 Ill. 2d 191, 205, 692 N.E.2d 295 (1998). Under such circumstances, the decision is based on fact-finding that is inseparable from the application of law to fact and is reviewed under a clearly erroneous standard. *Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369; see *AFM Messenger Service, Inc. v. Department of Employment Security,* 198 Ill. 2d 380, 391, 763 N.E.2d 272 (2001). This standard is largely deferential to the decision maker. *AFM Messenger Service, Inc.,* 198 Ill. 2d at 395; *Zebra Technologies Corp. v. Topinka,* 344 Ill. App. 3d 474, 480, 799 N.E.2d 725 (2003).

Under the clearly erroneous standard, a finding of the lower court may be reversed only if, after careful review of the entire record in light of the applicable rule of law, the reviewing court is left with the "'definite and firm conviction'" that the finding is in error. *Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369, quoting *AFM Messenger Service, Inc.,* 198 Ill. 2d at 395; *Zebra Technologies Corp.,* 344 Ill. App. 3d at 481. Purely factual findings are entitled to deference and are reversed only if they are contrary to the manifest weight of the evidence (*Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369; *Zebra Technologies Corp.,* 344 Ill. App. 3d at 480),

while pure questions of law are reviewed *de novo (Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369; *Zebra Technologies Corp.,* 344 Ill. App. 3d at 480), giving deference to the Department's interpretation of its governing statutes and its regulations (see *Automatic Data Processing, Inc. v. Department of Revenue,* 313 Ill. App. 3d 433, 443-44, 729 N.E.2d 433 (2000)).

The Illinois Income Tax Act (Act) provides that a corporate taxpayer conducting a multistate business in Illinois use the formula apportionment method of taxation. 35 ILCS 5/304(a) (West 2002)[2]; *Automatic Data Processing, Inc.,* 313 Ill. App. 3d at 438-39. Under the formula set forth in section 304(a), three factors, which are calculated in fractions, were used to apportion income: Illinois property in proportion to all property; Illinois payroll in proportion to all payroll; and Illinois sales in proportion to all sales. 35 ILCS 5/304(a) (West 2002); *Automatic Data Processing, Inc.,* 313 Ill. App. 3d at 439. The sales factor was double weighted. 35 ILCS 5/304(a) (West 2002); *Automatic Data Processing, Inc.,* 313 Ill. App. 3d at 439.

The Act defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business," which includes "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business." 35 ILCS 5/1501(a)(1) (West 2002); see also *Texaco-Cities Service Pipeline Co. v. McGaw,* 182 Ill. 2d 262, 267, 695

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[2] The Department notes that, starting in 1999, a single factor apportionment method based solely on sales has been applied. See 35 ILCS 5/304(h), 1501(a)(27) (West 2002).

N.E.2d 481 (1998). Because all of a business's income is presumed to be "business income" (see *Borden, Inc. v. Department of Revenue,* 295 Ill. App. 3d 1001, 1010, 692 N.E.2d 1335 (1998)), an "entity claiming that its income is nonbusiness income bears the burden of clearly proving this fact" (*Texaco-Cities,* 182 Ill. 2d at 268).

Mead contends that the income from the Lexis/Nexis sale was nonbusiness income, subject to allocation rather than apportionment, and that apportionment was unconstitutional. The Department counters that apportionment here passes constitutional muster because the requisite nexus to Illinois and rational relationship to Mead's business activities in Illinois existed. We agree.

Under the United States Constitution, the taxpayer must have "'some minimum connection'" to the taxing body and the tax must be "'rationally related to "values connected with the taxing [s]tate."'" *Hercules, Inc. v. Department of Revenue,* 324 Ill. App. 3d 329, 335, 753 N.E.2d 418 (2001), quoting *Quill Corp. v. North Dakota,* 504 U.S. 298, 306, 119 L. Ed. 2d 91, 102, 112 S. Ct. 1904, 1909-10 (1992), quoting *Moorman Manufacturing Co. v. Bair,* 437 U.S. 267, 273, 57 L. Ed. 2d 197, 204, 98 S. Ct. 2340, 2344 (1978). The due process and commerce clauses of the United States Constitution prohibit a state from taxing value earned "outside its borders" (*Home Interiors & Gifts, Inc. v. Department of Revenue,* 318 Ill. App. 3d 205, 210, 741 N.E.2d 998 (2000), citing *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 119 L. Ed. 2d 533, 112 S. Ct. 2251 (1992); *Hormel Foods Corp. v. Zehnder,* 316 Ill. App. 3d 1200, 1203, 738 N.E.2d 145 (2000)), but instead require that there be "'"some definite link, some minimum connection, between a state and the * * * transaction it seeks to tax"'" (*Hercules, Inc.,* 324

Ill. App. 3d at 336, quoting *Quill Corp.*, 504 U.S. at 306, 119 L. Ed. 2d at 102, 112 S. Ct. at 1909, quoting *Miller Brothers Co. v. Maryland,* 347 U.S. 340, 344-45, 98 L. Ed. 744, 748, 74 S. Ct. 535, 539 (1954)). States are permitted, however, to tax the multistate income of a nondomiciliary corporation where such minimal connection exists between the taxing state and the corporation's business activities and where a rational relationship exists between "'the income attributed to the taxing State and the intrastate value of the corporate business.'" *Hercules, Inc.,* 324 Ill. App. 3d at 336, quoting *Allied-Signal, Inc.,* 504 U.S. at 772, 119 L. Ed. 2d at 542, 112 S. Ct. at 2255. Further, the taxpayer has "'the distinct burden of showing by clear and cogent evidence that [the state tax] results' in the taxation of 'extraterritorial values.'" *Hercules, Inc.,* 324 Ill. App. 3d at 336, quoting *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 164, 77 L. Ed. 2d 545, 554, 103 S. Ct. 2933, 2939 (1983).

A state's apportionment of income of a multistate nondomiciliary corporation from a capital or nontangible transaction is constitutional in two circumstances: where there is a unitary business relationship between the payor and the payee or where the intangible asset served an operational rather than an investment function. *Hercules, Inc.,* 324 Ill. App. 3d at 336; see also *Allied-Signal, Inc.,* 504 U.S. at 787, 119 L. Ed. 2d at 552, 112 S. Ct. at 2263. Under the unitary relationship test, a single state may tax all the income earned and apportioned, even where a business has subsidiaries, divisions, or common ownership of other businesses that operate in different jurisdictions, if the businesses have common managerial or operational resources that "produce economies of scale and a substantial sharing of values." *Hercules, Inc.,* 324 Ill. App. 3d at

336; see also *Container Corp. of America,* 463 U.S. at 179, 77 L. Ed. 2d at 562, 103 S. Ct. at 2947.

Under the operational function test, even where no unitary relationship exists, a state may apportion income when the capital transaction serves an operational function rather than an investment function. *Hercules, Inc.,* 324 Ill. App. 3d at 337, see also *Allied-Signal, Inc.,* 504 U.S. at 787, 119 L. Ed. 2d at 552, 112 S. Ct. at 2263. There, the relevant inquiry focuses on the "'objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State.'" *Hercules, Inc.,* 324 Ill. App. 3d at 337, quoting *Allied-Signal, Inc.,* 504 U.S. at 785, 119 L. Ed. 2d at 550, 112 S. Ct. at 2262.

Mead does not dispute that Lexis/Nexis had the requisite connection, or nexus, with Illinois. Rather, it contends that taxation of the intangible income, including the gain on goodwill, from the Lexis/Nexis sale was unconstitutional because Mead and Lexis/Nexis were not unitary (as the circuit court found) and because its ownership of Lexis/Nexis did not serve an operational function, but merely an investment function. In response, the Department argues that the court erred by finding there was no unitary relationship and that, in any event, Mead failed its burden of proving that Lexis/Nexis was not an operational asset. Because we agree with the latter contention, we do not address the Department's claim of error as to the "lack of unitary business" finding.

Here, among its findings of contested facts, the circuit court found that Mead's investment in Lexis/Nexis "did serve an operational purpose, in that Lexis/Nexis represented a significant business segment of Mead." The court recognized that although, according to testimony of two of

Mead's witnesses, there was no functional integration of the companies, the court also found it was "not clear that there was no operational purpose." For that conclusion, the court relied upon the fact that Mead considered Lexis/Nexis in its strategic planning, particularly in the allocation of its resources. It concluded that the "operational purpose allowed Mead to limit the growth of Lexis/Nexis if only to limit its ability to expand or to contract through its control of capital investment."

In its challenge to that finding, Mead relies almost exclusively upon *Hercules, Inc.* and *ASARCO Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 73 L. Ed. 2d 787, 102 S. Ct. 3103 (1982), which is cited therein. In *Hercules, Inc.,* the court reversed a decision that all capital gains from a second corporation owned by the plaintiff corporation constituted apportionable business income because the court determined there was no operational purpose in the plaintiff corporation's investment in the second corporation. *Hercules, Inc.,* 324 Ill. App. 3d at 343-44. However, the facts of *Hercules, Inc.* are readily distinguishable from those in the instant case. There, gain at issue resulted from the plaintiff Hercules Corporation's sale of its minority stake in Himont, which had been formed by Hercules in a joint venture with a foreign corporation. The court rejected the argument that Hercules' investment in Himont served an operational purpose, based in part on Himont's "stand alone" status. *Hercules, Inc.,* 324 Ill. App. 3d at 338. Hercules never owned a majority share of Himont and it did not exercise management control over Himont.

Here, in contrast to Hercules' minority (38.7%) ownership and lack of management control over its subsidiary corporation, Mead was 100% owner of Lexis/Nexis.

Although Mead did not have day-to-day control over Lexis/Nexis, its involvement with Lexis/Nexis was more than merely passive. Mead developed Lexis/Nexis by contributing capital support until it become profitable. Further, Mead continued to approve major capital expenditures by Lexis/Nexis. It also manipulated Lexis/Nexis' business organization, treating it as either a division or a corporate subsidiary, depending on what was more beneficial to Mead. Additionally, Mead retained tax benefits and control over Lexis/Nexis' excess cash.

Moreover, in its own 1993 annual report, Mead identified itself as "the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information"; likewise, in its 1993 10-K form, Mead described itself as engaged in electronic publishing and included Lexis/Nexis in its discussion of business segments rather than its "investees." Compare *Allied-Signal, Inc.*, 504 U.S. at 788, 119 L. Ed. 2d at 552, 112 S. Ct. at 2263 (company's 20.6% ownership of subsidiary's stock did not establish operational relationship); *ASARCO Inc.*, 458 U.S. at 321-22, 73 L. Ed. 2d at 798-99, 102 S. Ct. at 3111-12 (bare majority ownership of stock not enough to show operational relationship in light of lack of ability to control subsidiary).

Mead also relies heavily in its challenge to the court's finding of operational purpose upon its assertion that the court improperly considered the annual report and the 10-K form in making that finding. However, Mead presents no relevant legal authority to support such assertion. Additionally, for the same point, Mead relies upon the testimony of its experts, particularly that of Dr. Ferdinand Schoettle, an economist, and Professor Richard Pomp, a tax law expert. However, experts may not testify with

respect to legal conclusions or give testimony amounting to statutory interpretations. *LID Associates v. Dolan,* 324 Ill. App. 3d 1047, 1058, 756 N.E.2d 866 (2001); *Coyne v. Robert H. Anderson & Associates, Inc.,* 215 Ill. App. 3d 104, 112, 574 N.E.2d 863 (1991). Therefore, Mead has not established that the court's finding of an operational purpose was against the manifest weight of the evidence (see *Zebra Technologies Corp.,* 344 Ill. App. 3d at 480), nor has it established as clearly erroneous the conclusion that the gain was nonbusiness income (see *Texaco-Cities,* 182 Ill. 2d at 268).

Next, Mead contends the gain was nonbusiness income under *Blessing/White, Inc. v. Zehnder,* 329 Ill. App. 3d 714, 768 N.E.2d 332 (2002), because it resulted from the liquidation of an entire line of business. The Department responds that Mead did not prove that the gain was not business income.[3] We agree.

As previously set forth, the Act defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business," which includes "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business." 35 ILCS 5/1501(a)(1) (West

[3] We note the Department's citation, as supplemental authority, of the 2004 amendment of the definition of business income in section 1501(a)(1), to now read that "the term 'business income' means all income that may be treated as apportionable business income under the Constitution of the United States." 35 ILCS 5/1501(a)(1) (West 2004). The Department contends that the amendment eliminated the language in section 1501(a)(1) that was relied upon in *Blessing/White, Inc.* to recognize the business liquidation exception to the functional test for business income.

2002). Two tests, corresponding to the two clauses in section 1501(a)(1), are applied to determine if income from the disposition of a capital asset is "business income." See *Texaco-Cities Service Pipeline Co.*, 182 Ill. 2d at 268. Under the first, the "transactional test," if the income is "'attributable to a type of business transaction in which [the] taxpayer regularly engages,'" it is business income. *Texaco-Cities Service Pipeline Co.*, 182 Ill. 2d at 269, quoting *National Realty & Investment Co. v. Department of Revenue*, 144 Ill. App. 3d 541, 554, 494 N.E.2d 924 (1986). Under the second test, the "functional test," all gain from the disposition of a capital asset is considered business income if the asset disposed of was "'used by the taxpayer in its regular trade or business operations.'" *Texaco-Cities Service Pipeline Co.*, 182 Ill. 2d at 269, quoting *National Realty & Investment Co.*, 144 Ill. App. 3d at 554

In the instant case, while Mead asserts that the gain did not satisfy either the transactional or the functional test, the conclusion reached as to the former test is undisputed. Therefore, we do not consider the transactional test, but only the functional test. Mead claims that the gain qualifies as nonbusiness income under a "modified" form of the functional test set forth in *Blessing/White Inc.*, 329 Ill. App. 3d 714.

There, the corporate taxpayer sold substantially all its assets, ceased doing business in Illinois, and distributed the proceeds to its individual shareholders. The court held that the functional test is satisfied in such cases only where the property and the liquidation of assets, *i.e.*, the disposition, are essential to the taxpayer's regular trade or operations. *Blessing/White, Inc.*, 329 Ill. App. 3d at 726. Further, the court found significant that the proceeds were "not used to support any ongoing business concerns but,

instead, disbursed in their entirety to the company's shareholders." *Blessing/White, Inc.*, 329 Ill. App. 3d at 728.[4]

Here, in contrast, there was no such disbursement to shareholders. Rather, Mead remained in business and reinvested the gain in its ongoing business. Mead paid federal taxes on the gain, then used about one-third of the proceeds to buy back stock and about two-thirds to reduce its debt level. While Mead argues that such actions increased the value of its shares, and thus benefitted its shareholders, we find such contention unpersuasive in this context. Mead reduced its debt levels and the company's long-term debt to capital ratio from 46% to 30.5%, and, using the Lexis/Nexis sale gain, increased its working capital to $807 million compared to $380 million the previous year. Further, unlike the Department's treatment of the taxpayer as two separate corporations under section 338(h)(10) of the Internal Revenue Code in *American States Insurance Co.*, 352 Ill. App. 3d at 531-32, the Department here claimed that Mead and Lexis/Nexis were unitary.

Mead also relies upon cases from foreign jurisdictions for its contention that the business liquidation exception should apply here. See, *e.g.*, *Lenox, Inc. v. Tolson*, 353 N.C. 659, 548 S.E.2d 513 (2001); *Laurel Pipe Line Co. v. Commonwealth*, 537 Pa. 205, 642 A.2d 472 (1994); *May*

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[4] The parties filed an agreed motion, which was granted, to cite as supplemental authority the decision, rendered after the briefs in this case were filed, in *American States Insurance Co. v. Hamer*, 352 Ill. App. 3d 521, 816 N.E.2d 659 (2004). In that case, the gain from the sale of a foreign corporation was properly treated as a deemed sale of assets, or nonbusiness income, rather than apportionable business income. *American States Insurance Co. v. Hamer*, 352 Ill. App. 3d at 532.

*Department Stores Co. v. Indiana Department of State Revenue,* 749 N.E.2d 651 (2001). For its part, the Department, recognizing its failure to raise such argument before the court below normally would result in waiver of the issue, nonetheless contends that *Blessing/White, Inc.* is contrary to Illinois law and provides inconsistent precedent with the "business liquidation exception" to the functional test for business income. On that basis, it asks this court to address that doctrine. However, having concluded that the Lexis/Nexis sale does not fall within the business liquidation exception, set forth in *Blessing/White, Inc.,* to the functional test for business income, we need not consider foreign authorities or address the validity of the business liquidation exception. Rather, because Mead reinvested the sale proceeds in its ongoing business, the court properly concluded that the gain satisfied the functional test and was properly identified as business income.

Finally, Mead contends that the inclusion of the Lexis/Nexis sale gain in its Illinois apportionable business income is unconstitutional because it is disproportionate to Mead's activities in Illinois. The Department responds that Mead never sought alternative apportionment (see 35 ILCS 5/304(f) (West 2002) (party seeking alternative apportionment must petition Director for it)) and that Mead has not proved by the clear and cogent evidence required that the income attributable to Illinois is "'out of all appropriate proportions to the business transacted'" in Illinois (*Container Corp. of America,* 463 U.S. at 170, 77 L. Ed. 2d at 556, 103 S. Ct. at 2942, quoting *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 135, 75 L. Ed. 879, 908, 51 S. Ct. 385, 389 (1931)). We agree and note the Department's point that, in the case

upon which Mead relies almost exclusively, *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 75 L. Ed. 879, 51 S. Ct. 385 (1931), a challenge to the three-factor formula (like the one used by the Department) was rejected by the United States Supreme Court, which held that such formula does not distort income attributable to the State. *Container Corp. of America,* 463 U.S. at 182-84, 77 L. Ed. 2d at 564-65, 103 S. Ct. at 2949-50 (no unconstitutional distortion even where combined apportionment converted net losses into substantial profits). See also *Pennzoil Co. v. Department of Revenue,* 332 Or. 542, 550 n.4, 33 P.3d 314, 318-19 n.4 (2001) (finding "*Hans Rees'* is of limited value" in the states using a multifactor apportionment).

Moreover, as the Department maintains, Mead did not establish that either it or Lexis/Nexis did not do substantial business in Illinois. As the Department notes, Mead's 1994 tax return indicates that the contrary is true: Mead reported Illinois sales of more than $338 million, of which over $46 million were attributable to Lexis/Nexis. Mead also relies upon a conclusion by its accounting expert, Kennion Yano, of distortion, but that testimony was considered by the circuit court, along with the auditor's criticism of Yano's evidence. The court ultimately struck Yano's conclusion. Mead has not proven clearly and cogently that the apportionment of the Lexis/Nexis gain was grossly disproportionate to its Illinois income or activities. For the reasons stated above, Mead has not established as clearly erroneous the court's conclusion that the gain from the sale of Lexis/Nexis was apportionable business income.

Mead also contends that the gross receipts from the sale of financial instruments should be included in the

calculation of its sales factor on its 1994 Illinois tax return.

This issue of whether the Department properly excluded from the sales factor denominator the $4.8 billion that Mead reported in gross receipts of financial instruments was decided on the parties' cross-motions for summary judgment. Accordingly, because the issue was resolved on motions for summary judgment, which is granted where the pleadings, depositions, admissions, and affidavits, if any, show that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law, review is *de novo.* 735 ILCS 5/2-1005(c) (West 2002); *Arangold Corp. v. Zehnder,* 204 Ill. 2d 142, 146, 787 N.E.2d 786 (2003).

As previously noted, section 304 of the Act, which governs business income of persons other than residents, provides in subsection (a) an apportionment formula for corporations conducting business in Illinois. 35 ILCS 5/304(a) (West 2002). As set forth in section 304(a), one of the factors used in calculating this formula is the "sales factor," which is "a fraction, the numerator of which is the total of sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year." 35 ILCS 5/304(a)(3)(A) (West 2002). Section 304 also explicitly allows for alternative allocation upon petition of either the taxpayer or the Director of the Department if the apportionment provisions "do not fairly represent the extent of [the taxpayer's] business activity in this State." 35 ILCS 5/304(f) (West 2002).

Mead relies on the definition in section 1501(a)(21) of the Act which states that "'sales' means all gross receipts

of the taxpayer not allocated under Sections 301, 302, and 303" (35 ILCS 5/1501(a)(21) (West 2002)) for its claim that the gross receipts from the sale of financial instruments should be included in the calculation of its sales factor on its 1994 Illinois tax return. Yet, section 1501 ("Definitions") provides generally that the stated definition applies "in this Act, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof" (35 ILCS 5/1501(a) (West 2002)), but, as noted, section 304, which addresses the "sales factor," explicitly allows for alternative allocation upon petition of either the taxpayer or the Director (35 ILCS 5/304(f) (West 2002)). Although "sales," then, may mean all gross receipts of the taxpayer that otherwise qualify as business income (see 35 ILCS 5/1501(a)(21) (West 2002)), under the standard apportionment formula, section 304 explicitly provides for modification of the apportionment provisions (35 ILCS 5/304(f) (West 2002)); therefore, we reject Mead's argument that the plain language of the statute requires the inclusion of the disputed gross receipts in the calculation of the sales factor.

Rather, in accordance with the authority granted by section 304(f), section 100.3380 of the Department's regulations was enacted. See 86 Ill. Adm. Code § 100.3380 (1996).[5] Section 100.3380(b)(6) provides special rules for computing the sales factor; one of those rules governs the sale of business intangibles and provides that "[i]n the case of sales of business intangibles * * * gross receipts

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[5] The Department notes that, in 2002, section 100.3380 was amended to state more explicitly that it was enacted in fulfillment of section 304(f) of the Act. See 26 Ill. Reg. 15304, 15314 (eff. October 9, 2002), codified, at 86 Ill. Adm. Code § 100.3380.

shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor." 86 Ill. Adm. Code § 100.3380(b)(6) (1996).

Mead asserts that the Department cannot "circumvent" the meaning of the statute by adopting a regulation. However, the Department has proper authority to make reasonable regulations, which have the force and effect of law. *Exhibits, Inc. v. Sweet,* 303 Ill. App. 3d 423, 427, 709 N.E.2d 236 (1998). The regulation, which is construed under the same standards governing the construction of statutes, is presumed to be valid, and the burden of establishing the regulation is unconstitutional is charged to the party challenging its validity. *Exhibits, Inc.,* 303 Ill. App. 3d at 427.

In its challenge to the validity of the regulation at issue, Mead relies primarily upon the testimony of its experts and a general principle concerning administrative rules. See *Canteen Corp. v. Department of Revenue,* 123 Ill. 2d 95, 108, 525 N.E.2d 73 (1988) (administrative rules can neither limit nor extend the scope of a statute).[6] While the Department questions the competency of the testimony of Mead's experts (see, *e.g., LID Associates,* 324 Ill. App. 3d at 1058), we do not find Mead's argument persuasive and, in any event, believe that section 304(f) of the Act and section 100.3380 were correctly applied here.

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[6] We note the additional foreign authority cited by the Department, including its supplemental authority, *Toys "R" Us, Inc. v. Franchise Tax Board,* 138 Cal. App. 4th 339, 41 Cal. Rptr. 3d 285 (2006), *Microsoft Corp. v. Franchise Tax Board,* 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal. Rptr. 3d 216 (2006), and *General Motors Corp. v. Franchise Tax Board,* 39 Cal. 4th 773, 139 P.3d 1183, 47 Cal. Rptr. 3d 233 (2006), in support of the exclusion of the gross receipts from the sale of financial instruments from the taxpayer's sales factor denominator.

Again, section 304(f) explicitly provides for modification of the apportionment provisions to avoid unfair representation of the extent of the taxpayer's business activity in Illinois. 35 ILCS 5/304(f) (West 2002). The inclusion of the gross receipts from the sale of financial instruments in Mead's sales factor denominator would not have resulted in a fair representation of its business activity; the gross receipts add approximately $4.8 billion to Mead's sales factor denominator when it actually earned only about $1.9 million on those investments. Accordingly, we believe summary judgment was properly granted in favor of the Department on this issue.

Therefore, we affirm the judgment of the circuit court as set forth in its orders of December 2, 2002, and March 18 and 25, 2003.

Affirmed.

McNULTY and O'MALLEY, JJ., concur.

## APPENDIX B

No. 1-03-1160

IN THE
APPELLATE COURT OF ILLINOIS
FIRST JUDICIAL DISTRICT

| | |
|---|---|
| THE MEAD CORPORATION, an Ohio corporation,<br><br>Plaintiff-Appellant,<br><br>v.<br><br>ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois,<br><br>Defendants-Appellees. | On Appeal from an Order of the Circuit Court of Cook County, Illinois, County Department, Law Division.<br><br>No. 00 CH 07854<br><br>The Honorable ALEXANDER P. WHITE, Judge Presiding. |

**ORDER**

(Entered Jan. 3, 2007)

THIS CAUSE COMING TO BE HEARD on the motion of the ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, former Director of the Illinois Department of Revenue and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois to Publish Rule 23 Order as a Precedential Decision, due notice having been given;

IT IS HEREBY ORDERED that the Motion to Publish Rule 23 Order as a Precedential Decision, is GRANTED/ ~~DENIED~~.

IT IS FURTHER ORDERED that: the Rule 23 order filed in this cause on November 3, 2006 is withdrawn, and an Opinion in the above-captioned cause will follow.

ENTER:

/s/ Justice Fitzgerald Smith
JUDGE

/s/ Jill K. McNulty
JUDGE

/s/ Denise M. O'Malley
JUDGE

DATED: [Stamped Jan. 3, 2007]

BRIAN F. BAROV
Office of the Attorney General
Civil Appeals Division

## APPENDIX C

IN THE CIRCUIT COURT
OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION
TAX AND MISCELLANEOUS REMEDIES SECTION

| | |
|---|---|
| THE MEAD CORPORATION,<br><br>Plaintiff,<br><br>v.<br><br>ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDY BAAR TOPINKA, Treasurer of the State of Illinois,<br><br>Defendants. | No. 00 CH 07854<br>Transferred to Law Division<br><br>Calendar 1<br>Judge Alexander P. White |

**FINAL JUDGMENT ORDER**

THIS CAUSE coming to be heard on the Defendants' Motion for Final Judgment, the parties represented through counsel, and being fully advised in the premises,

THE COURT HEREBY FINDS THAT:

A. All issues presented in the First Amended Verified Complaint have been resolved in favor of the Defendants by virtue of the findings of fact and conclusions of law reached in the Memorandum, Decision, Judgment and Orders entered on December 2, 2002, and March 18, 2003,

B. Because this action was initiated under the Protest Monies Act, no remand to the Department of Revenue is necessary,

C. No issues remain to be decided by this court except the entry of final judgment consistent with the court's rulings in the Memorandum Decision, Judgment and Orders entered on December 2, 2002, and March 18, 2003,

NOW, THEREFORE, THE COURT HEREBY ORDERS THAT:

1. The preliminary injunctions entered on March 3, 1999, and January 3, 2001, are dissolved;

2. Judgment is entered in favor of the Defendants and against the Plaintiff in the amount of $4,238,221, which represents the payments made under protest in the amount of $4,163,322 on February 3, 1999, and $74,889 on December 15, 2000;

3. The State Treasurer shall transfer the protest payments in the amount of $4,238,221 out of the Protest Fund and into the appropriate state fund;

4. This Final Judgment Order represents a complete disposition of all remaining issues in this matter, including a complete disposition of all issues remaining after the entry of the Memorandum, Decision, Judgment and Orders on December 2, 2002, and March 18, 2003, and is therefore a final and appealable order under Supreme Court Rule 303; and

5. Enforcement of this Final Judgment Order is stayed pending appeal without bond pursuant to Supreme Court Rule 305.

ENTER: /s/ Alexander P. White

DATE: [Stamped March 25, 2003]

LISA MADIGAN, Illinois Attorney General
BRIAN E. FLIFLET, Assistant Attorney General
Revenue Litigation Bureau
100 W. Randolph St., Room 13-225
Chicago, IL 60601
(312) 814-5685
Atty. No. 99000

## APPENDIX D

**IN THE CIRCUIT COURT OF
COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT - LAW DIVISION
TAX AND MISCELLANEOUS REMEDIES SECTION**

| | | |
|---|---|---|
| **MEAD CORPORATION,** | ) | |
| **Plaintiff,** | ) | |
| **vs.** | ) | |
| **ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDY BAAR TOPINKA, Treasurer of the State of Illinois,** | ) | **No. 00 CH 7854** |
| **Defendants.** | ) | |

**MEMORANDUM DECISION, JUDGMENT AND ORDER**

The matter is before the Court on the complaint filed by Plaintiff, Mead Corporation ("Mead"), against the Illinois Department of Revenue ("Department"), Glen L. Bower, and Judy Baar Topinka ("Defendants"). Mead objects to the assessment of the Department relative to the proceeds of the liquidation of the electronic publishing division of Mead which included Mead Data Central, Inc. (collectively referred to as "Lexis/Nexis").

**STATEMENT OF FACTS**

Plaintiff, Mead, filed Illinois corporate income and replacement tax returns for 1993 and 1994. On its 1993 return, Mead included Lexis/Nexis in its unitary business

group. On December 31, 1993, Lexis/Nexis merged into Mead as a division. Mead sold the assets of Lexis/Nexis to Reed Elsevier on December 2, 1994 for $1.5 billion. On its 1994 Illinois income and replacement tax return, Mead reported the gain on the sale as non business income.

The Department audited Mead for 1993 and 1994. Audit Adjustments made for 1993 are not disputed. For 1994, the Department determined the gain on the sale constituted business income and apportioned it to Illinois in accordance with the Illinois Income Tax Act (the "Act"). The Department also recomputed Mead's apportionment factor including in the denominator of the sale factor not only the gain realized but also the return of capital invested, as reported by Mead. This issue was dealt with in a separate proceeding. As a result, the Department issued a Notice of Deficiency which was paid under protest, and Mead filed this action pursuant to the Protest Monies Act.

## SUMMARY OF TESTIMONY OF WITNESSES BY PARTY

### 1. Plaintiff's Witnesses:

James P. Roemer, former head of operations of Mead Data Central, testified about the development of Lexis/Nexis during his tenure from 1970 until 1991, becoming acting president in 1982. He also testified to the nature of the relationship and the differences in culture and location between Mead and Lexis/Nexis during that time period.

James M. McGrane, currently an employee of Mead Corporation, testified about the relationship of the marketing and advertising functions at Mead and at Lexis/Nexis from the time he was hired by Lexis/Nexis in 1984 as director of market planning and development until

1994 when he was in Mead's strategy department having transferred there in 1992. He also testified to the relationship of his department within the operational structure of Lexis/Nexis.

Timothy R. McLevish testified he was an employee at Mead from 1987-92, vice president of financial resources and administration at Lexis/Nexis from 1992-93, and left Mead just prior to trial as their Chief Financial Officer. He testified to the changes in the legal structure of Lexis/Nexis and its effect on operations, and also how their finance departments interacted, both in terms of financial transactions and in terms of operations and policy making.

Walter Hellerstein, Professor of Taxation at the University of Georgia School of Law, was stipulated as an expert in the field of tax policy. Prof. Hellerstein testified as to his analysis of the question of whether the income derived from the disposition of Lexis/Nexis should be included in Mead's apportionable tax base for the State of Illinois.

Ferdinand P. Schoettle, Professor of Law at the Law School of the University of Minnesota and a private consultant, was stipulated as an expert in the field of economics. Dr. Schoettle testified as to his analysis of questions that go to the relationship between Mead and Lexis/Nexis.

Kennion K. Yano, Director of Deloitte & Touche L.L.P.'s Multistate Tax practice in Houston, Texas, was stipulated as an expert in the field of accounting. Mr. Yano testified as to his analysis of the 1994 Mead Company on a separate accounting basis in Illinois and the factor representation calculation on the gain on the sale of Lexis/Nexis.

Richard D. Pomp, Professor of Law at the University of Connecticut, Adjunct Professor of Law at New York University and Columbia University, and Visiting Professor every other year at Harvard Law School, was stipulated as an expert in the field of tax policy. Prof. Pomp testified as to his analysis which applied normative principles of state tax policy to determine if these principles would support the taxation of gain on the sale of Lexis/Nexis by the State of Illinois.

**2. Summary of Defendant's Witness:**

Frederick A. Murray, a revenue auditor for the Illinois Department of Revenue, testified on the conclusions reached by audit of the Mead Company's Illinois corporate income and replacement tax returns for 1993 and 1994.

**EXHIBITS**

**1. Stipulated before trial:**

Exhibit 1 – Illinois corporate Income and Replacement Tax Return for the year 1994

Exhibit 2 – Notice of Deficiency dates December 10, 1998

Exhibit 3 – February 3, 1999 payment and enclosed correspondence

Exhibit 4 – Agreed Order dated May 8, 2000

Exhibit 5 – Notice of Deficiency dated October 27, 2000

Exhibit 6 – December 15, 2000 payment and enclosed correspondence

Exhibit 7 – May 16, 1994 Mead Press Release

Exhibit 8 – Two Articles from Tuesday, May 17, 1994, *Dayton Daily News* entitled "Exiting info

highway, Mead to sell data unit, concentrate on forest products" (Summaries on right hand side of page 1A), and "3,800 workers include 2,000 employed here."

Exhibit 9 – Article from Tuesday, May 17, 1994, *Dayton Daily News* entitled "Mead plans future on paper."

Exhibit 10 – Mead's Motion for Partial Summary Judgment and Memorandum in Support of its motion

Exhibit 11 – Defendant's Response and Cross Motion for Partial Summary Judgment

Exhibit 12 – Mead's Reply Regarding its Motion for Partial Summary Judgment

Exhibit 13 – Order granting Mead's Motion for Partial Summary Judgment

Exhibit 14 – Qualifications of Professor Walter Hellerstein

Exhibit 15 – Qualifications of Professor Richard D. Pomp

Exhibit 16 – Qualifications of Dr. Ferdinand P. Schoettle

Exhibit 17 – Qualifications of Mr. Kennion K. Yano

Exhibit 19 – Illinois Corporate Income and Replacement Tax Returns for the year 1988, together with Notice of Disposition.

Exhibit 20 – 1988 IL 1120-X

Exhibit 21 – Auditor's Comments

Exhibit 22 – Illinois Corporate Income and Replacement Tax Returns for the year 1993

Exhibit 23 – 1993 Annual Report

Exhibit 24 – 1994 Annual Report

Exhibit 25 – 1993 Form 10-K

Exhibit 26 – 1994 Form 10-K

Exhibit 27 – Board of Directors minutes: 12/11/80, 7/26/84, 12/10/93, 2/24/94, 4/27/94, 4/28/94, 5/14/94, 8/4/94, 10/4/94, 10/29, 94, 12/9/94 (as redacted by Mead)

Exhibit 28 – Unanimous Written Consent of the Debt Committee, 12/3/94

Exhibit 29 – Mead Corp. Gross Receipts 1994

Exhibit 30 – Mead Corporation, report by Goldman, Sachs & Co., 10/21/94

Exhibit 31 – Mead Corporation: Alternatives for Reinvestment of MDC Proceeds, report by Goldman, Sachs & Co., 9/8/94

Exhibit 32 – Notices of Redemption to Bankers Trust Co. and Citibank, N.A., 12/6/94

Exhibit 33 – Press Release, Mead Board Authorizes Program for Stock Buyback; Debt Reduction, 10/31/94

Exhibit 34 – Press Release, Mead Corp. Board Calls Debentures for Redemption and Authorizes Repurchase of Notes, 12/7/94

Exhibit 35 – Memorandum from L. J. Frances to T. E. Palmer, MDC's Proposed Merger Writeup, 11/17/93

Exhibit 36 – Memorandum from Eve Kempfer to David A. Heuhardt, mead Data Central/Mead Digital Systems merger, with attachments, 1/13/80

Exhibit 37 – Recommendation to Board of Directors re: Liquidation/Merger of Mead Data Central Inc. and Mead Digital Systems Inc. 12/11/80.

**2. Admitted during trial:**

Plaintiff's Exhibit C: The Mead Corporation: 1994 Illinois Operations prepared by Mr. Yano of Deloitte & Touche

Defendant's Exhibit A: Workpapers of Mr. Murray, auditor for the Department of Revenue

**RULINGS ON CONTESTED ADMISSION OF EXHIBITS TAKEN UNDER ADVISEMENT**

IT IS HEREBY ORDERED THAT:

1. Defendant's objection to Plaintiff's Exhibit A: Expert Report of Walter Hellerstein as hearsay is denied and the report is admitted for the opinions expressed. The bases for the opinions are not accepted as substantive evidence.

2. Defendant's objection to Plaintiff's Exhibit B: Expert Report of Ferdinand P. Schoettle as hearsay is denied and the report is admitted for the opinions expressed. The bases for the opinions are not accepted as substantive evidence.

3. Defendant's objection to Plaintiffs Exhibit D: Expert Report of Richard D. Pomp as hearsay is denied and the report is admitted for the opinions expressed. The bases for the opinions are not accepted as substantive evidence.

4. Defendant's objections to the admissibility of testimony, which required reading from Plaintiff's Exhibit A, is denied.

5. Defendant's objections to the admissibility of testimony, which required reading from Plaintiff's Exhibit B, is denied.

6. Defendant's objection to strike reference to the outside experts during the testimony of Plaintiff's witness Dr. Schoettle as hearsay is sustained.

7. Defendant's objection to admit the statement of Mr. Yana, Plaintiff witness, that in his opinion the separate accounting calculation shows distortion as not relevant, is sustained.

8. Plaintiff's objection to question of Mr. Murray, regarding calculations relative to the correct denominator for the apportionment formula was determined by the Court in the motion for partial summary judgment.

## FINDINGS OF CONTESTED FACTS

### 1. Mead and Lexis/Nexis were not functionally integrated.

While Mead was more involved with Lexis/Nexis than with a passive investment, day-to-day Mead and Lexis/Nexis operated as two discrete entities. Mr. McGrane, who worked at Lexis/Nexis and then transferred to Mead, testified that there was no joint advertising, Lexis/Nexis had its own internal security department, its own human resources department, and its own facilities. Mr. McLevish testified that Lexis/Nexis had its own real estate department. The overlap of Board of Director involvement for extraordinary purchases requiring capital investment and the interest rate advantage gained by Mead through the nightly sweep of bank accounts is not sufficient evidence that the two were functionally integrated.

**2. Mead and Lexis/Nexis did not share a centralized management.**

Mead's involvement with Lexis/Nexis was primarily through approval of extraordinary purchases and considering the operations of Lexis/Nexis in its own strategic planning. That is not centralized management.

**3. There were no economies of scale realized by Mead and Lexis/Nexis.**

The testimony of Mr. McGrane explains that they had not shared facilities since 1984; they had separate purchasing departments and no joint purchasing activity. Mr. Roemer testified that Mead customers received no discounts if they were also Lexis/Nexis customers and vice versa. In addition, he testified that neither company enjoyed nor was offered a discount nor required to purchase the products or services of the other. The testimony was that Lexis/Nexis often bought paper from other vendors. According to Mr. McLevish, the only economy of scale presented was the increased interest rate enjoyed by Mead as a result of included Lexis/Nexis account balances in determining what interest rate applied.

**4. Mead was involved in the electronic publishing business.**

As the evidence stipulated to by the parties shows, Mead considered itself in the electronic publishing business in 1993 as attested to both in Exhibit 23, Mead's 1993 Annual Statement and in its 1993 Form 10-k. This was after the merger of the subsidiary into Mead. In 1994, after the sale of Lexis/Nexis both the Annual Statement and the Form 10-k reflect that Mead is no longer in the

electronic publishing business. Thus at all relevant times prior to the sale of Lexis/Nexis, Mead's business operations included Lexis/Nexis and, therefore, Mead was in the electronic publishing business.

**5. With its sale of Lexis/Nexis, Mead liquidated any interest in electronic publishing.**

The extent of Mead's operations in electronic publishing was represented by their interest in Lexis/Nexis. With the sale of Lexis/Nexis, all electronic publishing activities ceased. Evidence of that is provided by the 1994 Annual Statement and the 1994 Form 10-k, which make no mention of electronic publishing in its statement of business or its review of operations.

**6. Mead reinvested the proceeds from the liquidation of Lexis/Nexis in Mead.**

Based on stipulations made pretrial, the proceeds from the sale of Lexis/Nexis were used to repurchase Mead stock, retire debt and pay taxes. That has not been contested.

**7. The sale of Lexis/Nexis included assets which were situated in Illinois and used in the production of income reported to Illinois.**

That activity provides a nexus between Illinois and Lexis/Nexis that reaches the gain on the sale. Work papers provided by Mr. Murray and the report provided by Mr. Yano both show that there were assets, personnel and sales of Lexis/Nexis in Illinois for the 1994 year.

**8. Mead was not in the business of disposing operating divisions, and the sale of Lexis/Nexis was not in the ordinary course of business.**

Mead's operating divisions did not include a focus on disposing of large sections of its operations. Mead sale of Lexis/Nexis was a strategic decision to protect itself from take over through restructuring debt and repurchasing capital.

**9. Mead's returns which included Lexis/Nexis as part of its unitary group in 1994 does not create a presumption that a unitary relationship existed.**

Testimony indicated that the inclusion of Lexis/Nexis as part of Mead was originally a determination of the Department. Over the time that Lexis/Nexis was included as part of Mead's unitary group, Mead enjoyed substantial tax savings from an operating loss that would otherwise have expired. By that determination, Mead was compelled to file as unitary or appeal to the Department. Since it would be to their disadvantage to do so, the presumption acknowledged by their filing was that they were not actively seeking to pay more in income taxes.

**10. Mead's investment in Lexis/Nexis did serve an operational purpose, in that Lexis/Nexis represented a significant business segment of Mead.**

While it is clear from the testimony of Mr. McLevish and Mr. Roemer that there was no functional integration, it is not clear that there was no operational purpose. Lexis/Nexis was considered in the strategic planning of Mead, particularly in the allocation of resources. The

operational purpose allowed Mead to limit the growth of Lexis/Nexis if only to limit its ability to expand or to contract through its control of its capital investment.

**11. Mead is the appropriate entity to tax on the gain of the sale of Lexis/Nexis.**

The sale of Lexis/Nexis represented a complete liquidation of an operating segment of Mead. Mead reported that sale as part of its income as the sale of individual assets, with the balance as goodwill. As Mr. Murray testified, Lexis/Nexis was not a taxable entity and Mead was the entity required to report the gain.

**12. The amount of gain recognized as goodwill is gain attributable to the assets of Lexis/Nexis.**

The goodwill is identified as a lump sum gain. The auditor applied goodwill to the assets that were sold in the transaction and recognized the portion of that gain that applied to the assets in Illinois relative to total assets. If this is business income, that is a reasonable basis on which to allocate the gain.

## CONCLUSIONS OF LAW

**1. Mead and Lexis/Nexis are not unitary.**

As determined in the fact finding, Mead and Lexis/Nexis were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses. Filing as a unitary group at the direction of the Department of revenue is not sufficient to overcome the conclusion that the two entities are not unitary.

2. **The sale of Lexis/Nexis represented a liquidation in the business activity of electronic publishing, and the property disposed of in that liquidation was "essential to the taxpayer's regular trade or operations" and therefore business income.** *Blessing/White, Inc. v. Zehnder,* 329 Ill. App. 3d 714, 726.

The gain on the sale of Lexis/Nexis was part of the strategic business plan of Mead and the disposition of those assets was made for the benefit that the gain would provide to Mead. *Id.* at 728. Thus, the gain does meet the functional test and is properly identified as business income.

The Court determines that the case be sent to the Department of Revenue to recalculate the tax consistent with this opinion.

ENTER /s/ Alexander P. White
JUDGE Alexander P. White

[Stamped Mar. 18, 2003 Circuit Court – 241]

## APPENDIX E

**SUPREME COURT OF ILLINOIS**
**CLERK OF THE COURT**
SUPREME COURT BUILDING
SPRINGFIELD, ILLINOIS 62701
(217) 782-2035

January 24, 2007

Mr. Paul H. Frankel
Morrison & Foerster LLP
1290 Avenue of the Americas
New York, NY 10104

No. 103854 – The Mead Corporation, etc., petitioner, v. Illinois Department of Revenue et al., etc., respondents. Leave to appeal, Appellate Court, First District.

The Supreme Court today DENIED the petition for leave to appeal in the above entitled cause.

The mandate of this Court will issue to the Appellate Court on March 1, 2007.

## APPENDIX F

No. 1-03-1160

IN THE
APPELLATE COURT OF ILLINOIS
FIRST JUDICIAL DISTRICT

| | |
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| THE MEAD CORPORATION, an Ohio corporation,<br><br>Plaintiff-Appellant,<br><br>v.<br><br>ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois,<br><br>Defendants-Appellees. | On Appeal from an Order of the Circuit Court of Cook County, Illinois, County Department, Law Division.<br><br>No. 00 CH 07854<br><br>**[EXHIBITS INTENTIONALLY OMITTED]**<br><br>The Honorable ALEXANDER P. WHITE, Judge Presiding. |

### MOTION TO PUBLISH RULE 23 ORDER AS A PRECEDENTIAL DECISION

NOW COME the Defendants-Appellees, ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois (collectively "Department"), by and through their attorney, LISA MADIGAN, Attorney General of the State of Illinois, and pursuant to Supreme Court Rule 23(f) hereby move this Honorable Court to grant this motion to change the designation of the decision in this case from an unpublished order to a published opinion for the following reasons:

1. On November 3, 2006, this Court issued its Rule 23 Order upholding the circuit court's judgment that the gain Mead Corp. realized from its sale of Lexis/Nexis was Illinois apportionable business income and upholding the validity of section 100.3380(b)(6) of the Department's regulations, which prohibited Mead from including the return of principal from its investment in short-term financial instruments in its sales factor denominator as gross receipts.

2. Supreme Court Rule 23(a)(1) provides that a decision may be published where it "establishes a new rule of law or modifies, explains or criticizes an existing rule of law." This Court's decision qualifies as a publishable decision under Supreme Court Rule 23(a)(1). First, in upholding the Department's regulation, 86 Ill. Admin. Code § 100.3380(b)(6), it has established a new rule of law. Second, its finding that the gain from the Lexis/Nexis's sale was constitutionally apportionable in Illinois, and its finding that the gain from Lexis/Nexis's sale was not subject to the business liquidation exception to the functional test for business income explains existing rules of law, in a manner not previously found in any published decisions in Illinois.

**Validity of 86 Ill. Admin. Code § 100.3380(b)(6)**

3. This Court's holding that 86 Ill. Admin. Code § 100.3380(b)(6) is a valid exercise of the Department's authority under section 304(f) of the Illinois Income Tax Act, 35 ILCS 5/304(f) (2004), to modify apportionment methods to avoid the unfair representation of Illinois business activity, established a new rule of law on a recurring question for the Department. (*See* Affidavit of

Mark Hellner, Chief Counsel, at ¶ 3, attached hereto and made a part hereof as Exhibit A). The identical issue is before the Cook County Circuit Court in *Home Depot, U.S.A., Inc. v. Dep't of Revenue,* No. 05 L 50316, and briefing and argument on summary judgment has been stayed in that matter pending this Court's resolution of this case. (A true and correct copy of the order of March 22, 2006 in *Home Depot, U.S.A., Inc. v. Ill. Dep't of Revenue,* is attached hereto and made a part hereof as Exhibit B). There are also seven Protest Monies Act actions pending in the Sangamon County Circuit Court which will be impacted by this Court's decision on this issue: *Limited Stores v. Dep't of Revenue,* No. 99-TX-0001/02; *Limited Stores v. Dep't of Revenue,* 2000-TX-0001/2; *Limited Stores v. Dep't of Revenue,* No. 01-TX-0001/22; *Limited Stores v. Dep't of Revenue,* No. 03-TX-0001/13; *AT & T Corp. v. Dep't of Revenue,* 04-TX-0001/6; *Goldman Sachs v. Dep't of Revenue,* No. 06-TX-0001/5 and *Illinois Bell Telephone v. Dep't of Revenue,* No. 06-TX-0001/12. In addition, the validity of a related regulation, section 100.3380(c)(2) – which excludes occasional sales from the sales factor denominator – is in issue in *Lee Enterprises, Inc. v. Hamer,* No. 04 L 50884 (Cir. Ct. Cook Co.), and the principle established by this Court that the Department can provide an alternative apportionment method by regulation will be an important issue in this case. In these cases, publication of this decision will the assist the courts and promote judicial economy by avoiding relitigation of this issue.

**Constitutional Apportionment**

4. In finding that the gain from Lexis/Nexis's sale was constitutionally apportionable because Lexis/Nexis served an operational function for Mead, this Court

distinguished the present case from *Hercules, Inc. v. Dep't of Revenue,* 324 Ill. App. 3d 329 (1st Dist. 2001), the only other Illinois published decision addressing whether the gain from the sale of a business unit was constitutionally apportionable. In distinguishing the present case from *Hercules,* this Court has provided important guidelines for applying the operational function test that will assist the Department in administering the Illinois Income Tax Act ("IITA") and circuit courts in resolving disputes over whether a gain realized from the sale of a business asset is constitutionally apportionable.

5. The decision provides such crucial guidance on a recurring issue because it sets forth specific factors – such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits and control of excess cash – on which the Department, courts and taxpayers can rely in determining when a business unit qualifies as an operational asset and thus when the gain realized from its sale is constitutionally apportionable. In addition, the decision is significant because it approved of specific evidence on which the Department and courts can rely in making this determination – such as annual reports and federal 10-K statements – and disapproved of other evidence – the testimony of experts who offer opinions on matters of law – in deciding whether a business asset serves an operational function. *See* Hellner Aff., Ex. A. at ¶ 6.

**Business Liquidation Exception**

6. This Court also held that the gain was business income and did not qualify as nonbusiness income under the business liquidation exception to the functional test for

business income under *Blessing/White, Inc. v. Zehnder,* 329 Ill. App. 3d 714 (1st Dist. 2002) *and American States Ins. Co. v. Hamer,* 352 Ill. App. 3d 521 (1st Dist. 2004). In distinguishing this case from *Blessing/White* and *American States* this Court has established limits on the business liquidation exception that will provide significant guidance in administering the IITA. In particular, this Court's finding that Mead reinvested the gain in its ongoing business because it used the gain to buy back stock, pay down debt, reduce its long-term debt to capital ratio and increase working capital provides practical guidance for determining when the business liquidation exception applies and is the only published decision providing this analysis and distinguishing *Blessing/White* and *American States Ins. Co. See* Hellner Aff., Ex. A at ¶ 8. Thus, it will aid taxpayers and Courts, as well as the Department.

7. Indeed, although the business income definition was amended effective July 30, 2004 by Public Act 93-840, the scope and extent of the business liquidation exception to the business income definition remains a recurring issue affecting numerous tax disputes currently before the Department and the circuit court involving millions of dollars in disputed tax liability. *See* Hellner Aff., Ex. A at ¶ 7. The scope of the business liquidation doctrine is in issue in the Fourth District Appellate Court in *National Holdings, Inc. v. Zehnder,* No. 4-06-0148 (awaiting oral argument), in the First District Appellate Court in *Shakkour v. Bower,* No. 1-04-1646, *reh. den.* Oct. 13, 2006, *motion to pub. granted* Nov. 3, 2006, *pet. for leave to appeal due* Dec. 8, 2006, in the Circuit Court of Cook County in *Gannett Satellite Info. Network, Inc. v. Ill. Dep't of Revenue,* No. 03 L 51433, and *Lee Enterprises, Inc. v. Hamer,*

No. 04 L 50884, and in the Circuit Court of Sangamon County in *Limited Stores v. Dep't of Revenue,* No. 03-TX-0001/13; *Limited Stores v. Dep't of Revenue,* No. 01-TX-0001/22; *Brown and Williamson v. Dep't of Revenue,* No. 03-TX-0001/14; *CR Bard, Inc. v. Dep't Revenue,* No. 04-TX-0001/02; *EPCO, Inc. v. Dep't of Revenue,* No. 03-TX-0001/12; *Nationwide Mutual v. Dep't of Revenue,* No. 01-TX-0001/23; and *Nicor, Inc. v. Dep't of Revenue,* No. 98-TX-0001/11. A published decision in the present case will benefit the courts and litigants in resolving these pending actions.

For the foregoing reasons, the Defendants-Appellees respectfully request that this Honorable Court publish the Rule 23 order, entered on November 3, 2006, as a precedential decision.

Respectfully submitted,

LISA MADIGAN
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State of Illinois

BY: /s/ Brian F. Barov

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## APPENDIX G

EXPERT REPORT OF WALTER HELLERSTEIN

Prepared for Morrison & Foerster
Counsel for The Mead Corporation

in connection with

The Mead Corporation v.
Illinois Department of Revenue, et al.,

No. 00 CH 07854

In the Circuit Court of Cook County, Illinois
County Department, Law Division
Tax and Miscellaneous Remedies Section

Dated September 20, 2001

**[EXHIBIT A RESUME INTENTIONALLY OMITTED]**

[1] 1. I am Walter Hellerstein, the Francis Shackelford Professor of Taxation at the University of Georgia School of Law, where I have taught since 1978. I have devoted most of my professional life to the study of state and local taxation and have written extensively about state and local taxation. My experience and scholarly work in the field of state and local taxation are reflected in my current resume, which I have attached hereto as Exhibit A. I have prepared this report for use by Plaintiff in connection with the above captioned litigation.

2. I have been accepted as an expert witness on matters involving state and local taxation in *Appeal of Panhandle Eastern Pipe Line Co., et al.*, Nos. 98-6865-DT, 98-6866-DT, Kansas Board of Tax Appeals, Sept. 16, 1999; *Springs Industries, Inc. v. South Carolina Department of Revenue*, No. C.A. No. 99-ALJ-17-0153-CC, South Carolina Administrative Law Judge Division, May 26, 1999; *Pennzoil Company and Subsidiaries v. Department of Revenue*,

No. 4301, Oregon Tax Court, March 10. 1999; *In the Matter of the Protest of KMART Properties, Inc.*, ID No. 02-297446-00 6, Assessment Nos. 213646 and 213647, Before the Taxation and Revenue Department of the State of New Mexico, Nov. 20, 1998; *The Williams Companies Inc & Subsidiaries v. Department of Revenue of the State of Montana*, Case No. CT-1996-1, Montana State Tax Appeal Board, July 27-28, 1998; *General Motors Corporation, et al. v. Director of Revenue, State of Missouri*, Cause No. 96-001882RI, Missouri Administrative Hearing Commission, August 18, 1997; *Fleming Foods of Texas, Inc. v. Sharp*, No. 96-12390, Travis County, Texas District Court, 53rd Judicial District, March 10, 1997; *General Motors Corporation d/b/a General Motors Emissions Laboratory v. City and County of Denver*, No. 950401, Treasury Division, Department of Revenue, City and County of Denver, July 23, 1996; *In re Chrysler [2] Corporation*, No 40-910308-2, Philadelphia Tax Review Board, Sept. 14, 1995; *Mississippi Power & Light Co., et al. v. Mississippi State Tax Commission*, Civil Action Nos. 154,261-154,263, Chancery Court of the First Judicial District of Hinds County, Mississippi, December 13, 1994; *Peabody Coal Co. v. The Navajo Nation*, No. CIV 88-0931-PCT-BMV, United States District Court for the District of Arizona, March 18, 1994; *Chevron U.S.A., Inc. v. Mississippi State Tax Commission*, Cause No. 148,792, Chancery Court of the First Judicial District of Hinds County, Mississippi, January 25, 1993; *H. A. True. Jr., et al. v. Tax Commissioner of the State of North Dakota*, Civil No. 38367, North Dakota District Court, South Central Judicial District, Burleigh County, October 12, 1989; *American Telephone & Telegraph Co. v. Commissioner of Revenue*, Docket Nos. 146547-146550, Massachusetts Appellate Tax Board, June 7, 1989; *J.C. Penney Co. v. City of Tacoma*, Docket No. 271861, Superior

Court, Pierce County, State of Washington, March 10, 1989; *American Telephone and Telegraph Co. v. State Tax Appeal Board*, Docket No. CDV 86-823, District Court of the First Judicial District of the State of Montana, Lewis and Clark County, June 6, 1988; *Burlington Northern Railroad Co. v. Wyoming State Tax Department*, No. C-87-0252, United States District Court for the District of Wyoming, May 1, 1988; *Union Pacific Railroad Co. v. Public Utility Commission of the State of Oregon*, Civil No. 86-778-PA, United States District Court for the District of Oregon, July 13, 1987; *Kansas City Southern Railway v. McNamara*, 624 F. Supp. 395 (M.D. La. 1985); *In re Factual Issues in Cause No. 83-551 of the Supreme Court of Montana (Burlington Northern, Inc. v. Schwinden)*, District Court of the First Judicial District of the State of Montana, Lewis and Clark County, May 25, 1984; and *Alabama Great Southern Railway v. Eagerton*, 541 F. Supp. 1084 (M.D. Ala. 1982).

[3] 4. I have testified at the invitation of Committees of the United States Congress on matters involving state and local taxation in *Hearings on H.R. 1054, the "Internet Tax Freedom Act," Before the Subcomm. on Commercial and Administrative Law of the House Committee on the Judiciary*, 105th Cong., 1st Sess. (July 17, 1997); *Hearings on the Effect of Interstate Branching on National, State, and Local Economies Before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance, and Urban Affairs*, 102d Cong., 1st Sess. (May 15, 1991), *Hearings on the Interstate Sales Tax Collection Act of 1987 and the Equity in Interstate Competition Act Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary*, 100th Cong., 2d Sess. (Sept. 21, 1988), *Hearings on the Severance*

*Tax Equity Act of 1982 Before the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance*, 98th Cong., 2d Sess. (July 24, 1984), and *Hearings on the Commerce Clause and State Severance Taxes Before the Subcommittee on Intergovernmental Relations of the Senate Committee on Government Affairs*, 97th Cong., 1st Sess. (July 15, 1981). I have testified before state legislative bodies in the following states on the following matters relating to state and local taxation: Florida, sales tax on services; Georgia, severance tax on kaolin; Louisiana, coastal wetlands environmental levy; Michigan, Single Business Tax apportionment; and Texas, criteria for a viable state tax structure. I have testified at the invitation of the Advisory Commission on Electronic Commerce created by Congress on "The Law of Sales Taxation in a Cyberspace Economy" (June 22, 1999).

5. I have consulted with states and with private industry on a wide variety of issues involving state and local taxation and related matters. My consulting activities with states [4] include: Alaska, providing advice regarding the constitutionality of proposals to revise Alaska's oil and gas income tax and drafting substantial portions of the state's briefs in *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984); Delaware, providing advice regarding state income tax issues; Florida, drafting legislation for a sales tax on services and defending the constitutionality of the legislation in the Florida courts; Georgia, providing advice to the Georgia Department of Revenue on income, sales and use, and property tax issues; Louisiana, drafting legislation for a coastal wetlands environmental levy and defending the constitutionality of the legislation before legislative bodies; Montana, drafting substantial portions of the state's briefs

in the state district court, the state supreme court, and the United States Supreme Court defending the constitutionality of Montana's coal severance tax in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981); North Dakota, providing expert assistance in a state income tax controversy; Texas, serving as a consultant to the Texas Select Committee on Tax Equity; and Virginia, defending the State Department of Revenue in an income tax refund suit. My consulting activities with private industry include advice and assistance on income, sales and use, property, and miscellaneous excise taxes, particularly with regard to federal constitutional issues raised by such levies, and I have participated on behalf of private industry in litigation before the United States Supreme Court in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987), *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), *Trinova Corp. v. Michigan Department of Treasury*, 498 U.S. 358 (1991), *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334 (1992), *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), a case I argued; *Colgate Palmolive Co. v. Franchise Tax* [5] *Board*, 512 U.S. 298 (1994), *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997), and *Hunt-Wesson, Inc. v. Franchise Tax Board.*, 528 U.S. 458 (2000), a case I argued.

6. I have frequently been a faculty member at continuing education programs devoted to state and local taxation, as indicated on pages 2-4 of my resume (see Exhibit A).

7. Based on my review of various documents produced by the parties in this case, including Plaintiff's

Response to Defendants' First Set of Written Interrogatories dated August 20, 2001, Plaintiff's First Amended Verified Complaint and Exhibits A, B, C, and D thereto filed January 4, 2001, the Reply of Plaintiff filed April 26, 1999, the Answer of Defendants filed April 2, 1999, and on conversations with employees of the Mead Corporation and with counsel, and relying on materials regularly and reasonably relied upon by persons in my field and on my own knowledge of the law and policy relating to state taxation, my opinions and conclusions at this time are as follows:

**Mead and MDC Were Two Discrete Business Enterprises Engaged in Unrelated Business Activity, and Illinois Therefore May Not Include Mead's Income From Its Sale of MDC in Mead's Apportionable Tax Base**

During the tax year at issue (1994), and, indeed, for many years prior to 1994, The Mead Corporation ("Mead") and Mead Data Central ("MDC"), were two discrete business enterprises that were engaged in unrelated business activities. Consequently, Illinois may not require Mead to include in its apportionable tax base the income it earned from its 1994 sale of MDC. My opinion and conclusion are based on the following facts and analysis.

Mead was engaged in the business of producing and selling forest products, including paper, packaging and paperboard, and school and office supplies. MDC was in [6] the business of providing online information services for legal, news, and financial information. Indeed, MDC was a pioneer in the field of computer-assisted research, having developed the LEXIS/NEXIS service in the 1970s.

From the time of its acquisition by Mead in 1968 through its sale in 1994, MDC operated as an enterprise that was discrete from, and unrelated to, Mead's other lines of business. In fact, apart from ownership, there were no substantial unitary or operational connections between Mead's core forest products and related businesses and MDC's on-line information service business. Specifically:

1. *There was no meaningful functional integration between Mead and MDC.* Because they were involved in discrete and unrelated enterprises, there were almost no flows of goods, personnel, or intangible values between the two enterprises. Mead's purchases of information services from MDC amounted to less than one-tenth of one percent (0.1%) of its purchases. Similarly, MDC's purchases of forest products from Mead amounted to less than one-tenth of one percent (0.1%) of its purchases. By any reasonable standard, such de minimis intercompany product flows fall beneath the level that would constitute functional integration.

Moreover, the respective products produced by Mead and MDC fell outside each of the other enterprise's core (and discrete) lines of business. When Mead purchased information services from MDC, it was acquiring services that were peripheral to its core business – production and sale and forest products. Similarly, when MDC purchased forest products from Mead, it was acquiring products that were peripheral to its core business – providing an on-line data base. Furthermore, such purchases were all made on [7] an arm's-length basis on the same terms that they would have been made between unrelated parties.

There was likewise little interchange of personnel between Mead and MDC. Because of the disparate nature

of their operations, there was little opportunity for employees in Mead's forest products and related operations to serve any useful function in MDC's information services businesses. By the same token, there was little opportunity for employees in MDC's information services business to serve any useful function in Mead's forest products and related operations.

There was no flow of intangibles between Mead and MDC that can be characterized as functional integration. Mead did not share the patents, trade secrets, or other intellectual property developed in its forest products business with MDC and MDC did not share the patents, copyrights, trade secrets, or other intellectual property developed in its on-line information business with Mead.

2. *There was no meaningful centralized management of Mead's and MDC's operations.* Mead and MDC were managed as separate and discrete enterprises. Except for the type of occasional oversight that any parent or owner gives to an investment in a subsidiary or a division, there was no centralized management of Mead and MDC. MDC's management made all of its day-to-day operating decisions independently without Mead's approval.

3. *There were no economies of scale that Mead and MDC enjoyed as a result of their relationship.* Because Mead and MDC were engaged in such fundamentally different and unrelated enterprises, there were no economies of scale that accrued to Mead or MDC as a result of their common ownership. Both Mead and MDC had their [8] own purchasing departments, and there was no joint purchasing of the supplies or inputs that were essential to either Mead's or MDC's core businesses. Mead's purchases of timberlands or other goods and services related to its

forest products business were not increased by any purchasing requirements of MDC. Similarly, MDC's purchases of information data bases and other goods and services related to its on-line information service business were not increased by any purchasing requirements of Mead. Indeed, MDC relied substantially on its own internal resources (including software and data base designers), which were wholly unrelated to Mead's operations, in developing its on-line information business. Moreover, there was little sharing even beyond the two enterprises' core businesses. For example, there were no centralized computer services and MDC did not purchase its paper from Mead.

4. *There was no substantial flow of value between Mead and MDC.* Because the relationship between Mead and MDC reveals no substantial functional integration, no centralized management, and no economies of scale, there was no substantial flow of value between the two enterprises. Moreover, as noted above, there is no evidence of sharing of intangible values between the two enterprises that might be characterized as a substantial flow of value. Mead did not share the intellectual property developed in its forest products business with MDC and MDC did not share the intellectual property developed in its on-line information business with Mead.

There was no overall corporate culture that Mead imparted to MDC. To the contrary, the corporate cultures of the two enterprises were quite different – almost adversarial or hostile. Each enterprise had its own, separate physical facilities. Each had its own security procedures, so that employees of Mead did not have ready access to the [9] facilities of MDC. And each had its own dress code,

reflecting the more formal atmosphere at Mead and the more casual atmosphere at MDC.

5. *Mead did not serve an operational function in MDC's business and MDC did not serve an operational function in Mead's business.* In light of the facts set forth above, it is apparent that neither Mead nor MDC served an operational function in each other's discrete business. From Mead's standpoint, the only operational connection between it and MDC were the information services that MDC provided to Mead. Not only were these de minimis – less than one tenth of one percent (0.1%) of Mead's purchases – but they were peripheral to Mead's core operations, which involved forest products, not information. Moreover, Mead purchased the services at arm's length from MDC. From MDC's standpoint, the only operational connection between it and Mead were the general oversight that any owner of a discrete business enterprise provides to a subsidiary or division and some incidental management services that had no relationship to MDC's core business, the providing of information services.

In summary, because the relationship between Mead and MDC involved no meaningful functional integration, centralized management, or economies of scale; because there was no significant flow of value between Mead and MDC; and because neither Mead nor MDC served an operational function in each other's business, Illinois lacks the power to include the gain that Mead (a nondomiciliary corporation) earned from its disposition of MDC.

This conclusion follows from the fundamental requirement governing the exercise of state taxing power that there must be some definite link or minimum connection between a state and both the person and the activity

that the state seeks to tax. It is well [10] settled that in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the state seeks to tax. The underlying rationale for this virtually axiomatic proposition is that the exercise of a state's tax power over a taxpayer's activities is justified by the protection, opportunities and benefits the state confers upon such activities. If the state lack the definite link or minimum connection with the activities in question, it has not given anything for which it can ask return.

In this case, Illinois lacks the authority to include the gain that Mead derived from its sale of MDC in Mead's apportionable tax base because it lacks the definite link or minimum connection with the activity that produced that gain. The activity that produced Mead's gain from the sale of MDC was Mead's activity as an investor in a discrete and unrelated enterprise. This activity occurred in Mead's headquarters and commercial domicile of Ohio, not in Illinois. Accordingly, Illinois lacked the power to include Mead's gain from the sale of MDC in Mead's apportionable tax base.

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## APPENDIX H

## [1] EXPERT OPINION OF PROFESSOR RICHARD D. POMP[1]

### The Mead Corporation v. Illinois Dept. of Revenue

### I. Introduction

You have contacted me as the former Director of the New York Tax Study Commission and as someone who for nearly 25 years has studied, lectured, taught, published, and consulted with, and testified on behalf of state governments, on the subject of state taxation. You have asked me to comment on how the normative principles of state taxation should be applied to The Mead Corporation (Mead). Specifically, you asked my opinion regarding the proper treatment from a policy perspective of the receipt by Mead in 1994 of gain on the liquidation of its ownership of Mead Data Central, which represented the complete disposition and liquidation of Mead's separate and distinct electronic publishing business.

### II. Background and Overview

Mead is headquartered and commercially domiciled in Ohio. Mead's core business is in the paper and timber business: packaging and paperboard, forest products, timberlands, and school and office products. In 1968, Mead acquired Data Corporation, an incipient electronic publisher that would go on to provide online information services involving legal, news and financial information.

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[1] Alva P. Loiselle Professor of Law, University of Connecticut Law School; Adjunct Professor of Law, NYU Law School (LL.M Program in Taxation); Adjunct Professor of Law, Columbia Law School; former Director, N.Y. Tax Study Commission.

Data pioneered the field of computer assisted research in the early 1970's with its LEXIS and, subsequently, its NEXIS service, and will hereinafter be referred to as Lexis/Nexis. In 1994, Lexis/Nexis[2] was sold to Reed Elsevier plc. The sale represented the complete disposition and liquidation by Mead of its electronic publishing business. The proceeds of the liquidation were primarily used by Mead to buy back its stock and to reduce its debt.

Mead has nexus with Illinois. In filing its Illinois income tax return, Mead classified the gain on the liquidation of Lexis/Nexis as nonbusiness income.[3] The Illinois Department of [2] Revenue (Department) has challenged this characterization, arguing that the income should be treated as business income[4] and apportioned to Illinois by Mead.

## III. Normative policy considerations governing the income taxation of multistate corporations

Normative principles of state tax policy dictate that a state can tax only those corporations with which it has a minimum connection, relationship, or nexus. Even if this minimum relationship exists, however, a state

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[2] During some years, Lexis/Nexis was owned in the form of a subsidiary, known as Mead Data Central, Inc.; in other years, Lexis/Nexis was a division of Mead. In 1994, the year of the sale, Lexis/Nexis was a division. The manner in which Mead owned Lexis/Nexis is irrelevant to the analysis in the text.

[3] 35 ILCS 5/1501(a)(13).

[4] For the definition of business income, see 35 ILCS 5/1501(a)(1). Nonbusiness income is defined as "all income other than business income or compensation." 35 ILCS 5/1501(a)(13).

cannot tax the entire income of a non-domiciliary corporation. A state cannot tax income earned outside its borders but is limited to taxing only income attributable to activities taking place within its borders. A state needs some method for determining how much of the income of a multistate corporation should be considered as earned within its borders.

Principles of state tax policy also mandate that a rational relationship must exist between the income that a state attributes to itself and the intrastate activities of the taxpayer. In other words, a state may tax only income that is fairly apportioned to a corporation's activities in the taxing state.

There are three general approaches for applying these principles in determining whether, and how, a state may tax the income of a corporation: separate accounting, formulary apportionment, and specific allocation.

Under separate accounting, the Illinois income of a multistate corporation like Mead would be determined by isolating through accounting techniques the taxable portions of the corporation that are carried on within the State. Because Mead is a multistate corporation, separate accounting would isolate those income-generating activities that take place in Illinois and determine how much income is attributable to such activities.

The second of the three methods is known as formulary apportionment, which is the method that the Department is seeking to use in this case. Under this approach, a formula is used to apportion Mead's unitary business income to those states in which it has payroll, property, or sales. More specifically, the formula is used to generate an

apportionment percentage that is based on the relative amount of a taxpayer's in-state activities.

[3] One common formula that is used elsewhere in the country, but not in Illinois, uses the average of a taxpayer's payroll, property, and sales, with each factor being evenly weighted. During the year at issue, in 1994, Illinois used a variation on this formula in which it double weighted the sales factor. Specifically, Illinois used the following formula for apportioning the unitary business income of a multistate corporation, which the Department asserts should also be applied to the gain on the liquidation of Lexis/Nexis:

$$TI_{IL} = TI_{WW} \times 1/4\ (2 \times Sales_{IL}/Sales_{WW} + Payroll_{IL}/Payroll_{WW} + Property_{IL}/Property_{WW})$$

Where:

(1) $TI_{IL}$ is the amount of the corporation's total taxable income, computed under Illinois law, which is apportioned to Illinois;

(2) $TI_{WW}$ is the amount of the corporation's total taxable income apportionable under Illinois law;

(3) $Sales_{IL}$ is the amount of the corporation's sales within Illinois;

(4) $Sales_{WW}$ is the amount of the corporation's total sales;

(5) $Payroll_{IL}$ is the value of the corporation's payroll in Illinois;

(6) $Payroll_{WW}$ is the value of the corporation's total payroll;

(7) $Property_{IL}$, is the value of the corporation's property located in Illinois;

(8) $Property_{WW}$ is the value of the corporation's total property.

The virtue of using a formula to determine Illinois's share of a multistate corporation's unitary business income can be illustrated by considering Mead. Mead is a multistate corporation whose core business is a vertically integrated manufacturing operation, starting with the growing of timber used in making paper, and culminating with the sale of paper and paper-related products. Mead has activities throughout the country, with property, payroll, and sales located in many states. The formula allows Illinois to answer the otherwise difficult question of how much of Mead's income was sourced to Illinois through the application of a formula. In applying the formula to Mead's operating business income, Illinois determines what share of such income can be properly attributable to the corporation's activities in the [4] State.

A way of understanding the formula is to think of the total operating income generated by Mead as a pizza pie. The formula is used to determine Illinois' slice of the pizza. In determining the size of the pizza pie, only income having some sufficient connection with Illinois can be included.

As a policy matter, the pizza should include only income with which Illinois has some reasonable relationship. For example, if by chance Mead happened to operate a pharmacy in California, having nothing to do with the paper business, the income from that discrete unrelated business would not, as a policy matter, be included in the pizza. Because the pharmacy would be unconnected with Mead's other operating income, Illinois should not be able to tax a

share of the pharmacy's income. Illinois simply has no "hook," connection, or relationship with that income. Accordingly, the income from the pharmacy would not be included in the pizza and the factors of the pharmacy would not enter into the calculation of Mead's Illinois apportionment percentage. The result is that Illinois would not be taxing the out-of-state activities of a business (the pharmacy) that has no relationship to anything taking place in Illinois.[5]

The normative principle that only income that is related to Mead's Illinois business operations can be included in the pizza and apportioned to Illinois is of especial importance to this case. The controversy in this case is whether the income from the liquidation of Lexis/Nexis has a sufficiently close relationship with Illinois so that it can be included in the pizza and apportioned to the State using the formula that applies to the regular operating income generated by Mead.

Not including the liquidation income in the pizza does not mean that Illinois, as a policy matter, can not tax it. To the contrary, the third of the three approaches for determining when a state can tax income, known as specific allocation, applies to income that is not subject to formulary apportionment. Specific allocation assigns certain types of income to a state using non-formulary rules. If formulary apportionment can be viewed as determining a state's slice

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[5] If the pharmacy were located in Illinois, its operating business income could be taxed notwithstanding that there was no relation with Mead's paper business. The pharmacy's operating business income could be taxed because of its relationship to Illinois independent of the relationship of Mead's paper business to the State.

of a pizza, specific allocation can be viewed as giving a scoop of ice cream in its entirety to one state.

[5] Formulary apportionment and specific allocation co-exist. A corporation will apportion its business income and allocate its non-business income.

This case is about whether the income from the liquidation by Mead of Lexis/Nexis should be added to the pizza and apportioned to the State, as the Department wishes, or whether it should be viewed as having nothing to do with Mead's Illinois business, and as being unrelated in any other way to activities in Illinois, and thus subject to the Illinois rules on specific allocation.

One final normative principle that has a bearing on this case is that the apportionment formula should not be inherently or intrinsically arbitrary. It must reflect a reasonable sense of how income is generated. The formula must produce a fair result in light of the taxpayer's activities in the state. In making this determination, separate accounting is often used as a check on the result reached by formulary apportionment. Some ability to check the formula is required because the formula is not based on any scientific or economic theory. The formula grew out of a political compromise between the so-called "origin" states, where manufacturing took place, and the so-called "market" states, where the manufactured goods were sold.

The early apportionment formulas were either one or two factors: property and/or payroll. The market states complained that these factors were too favorable to the origin states and did not fairly share the corporate tax base with the market states. In response to this criticism, a sales factor was added to the apportionment formula.

A formula that reflects a political compromise more than economic theory is unlikely to work well under all circumstances[6] and as a policy matter, some means, like separate accounting, is necessary to determine whether the formula may be overreaching or working improperly under certain conditions.

As applied to the case at issue, the above policy considerations require determining whether the relationship among Illinois, Mead, and Mead's operation and liquidation of Lexis/Nexis justifies Illinois treating the gain on the liquidation as part of Mead's Illinois income. In other words, does a sufficient relationship exist between Mead's Illinois activities and the liquidation income so that such income can be added to the pizza pie and apportioned to [6] Illinois. Alternatively, are there other connections between the liquidation gain and Illinois that could justify Illinois apportioning the income.

## IV. Application of the above principles to Mead's liquidation of Lexis/Nexis

Under normative principles of taxation, for Illinois to apportion the gain on Mead's liquidation of Lexis/Nexis, such income must be part of the business income of Mead. There are two ways in which the liquidation gain might be considered to constitute apportionable business income of Mead and both are considered below.

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[6] A Nobel Prize winning economist described the three factor formula as "[t]his simple but arbitrary and capricious formula has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they ever were taught about statistics or economics." William Vickrey, The Corporate Income Tax in the U.S. Tax System, 73 Tax Notes 597, 602 (1996).

### A. Policy considerations regarding whether Lexis/Nexis served an operational function with respect to Mead's Illinois business operations

One principled way for Illinois to apportion the liquidation income is if Mead's ownership of Lexis/Nexis served an "operational function" with Mead's Illinois business operations. From a policy perspective, determining whether an operational function exists requires analyzing the objective characteristics of Lexis/Nexis and its relation to Mead and Mead's activities in Illinois. One example of an operational function would be if Lexis/Nexis generated working capital from its business operations for Mead's paper business. In that event, the business income generated by Lexis/Nexis should be included in Mead's apportionable income.[7] I do not believe, however, that anyone could seriously argue that Mead invested its working capital in Lexis/Nexis or that the income generated by Lexis/Nexis was used by Mead for its working capital.

Another reason why the gain does not serve an operational function is because the sale resulted in the complete liquidation of a separate and distinct line of business.

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[7] The fact that a corporation might have included income from a non-unitary business in its apportionable income does not show that a unitary or operational relationship existed between the businesses. Taxpayers will often include non-unitary income with unitary income because of the simplicity and ease of preparing the tax return. It could be more difficult to carve out and segregate the income and factors of a non-unitary business than simply treating such business as if it were part of the unitary business. To be sure, if the amount of tax at stake is large, a corporation will endure the additional administrative expenses of preparing the computations, but otherwise administrative convenience may outweigh the additional tax that might be paid by treating the non-unitary business as if it were unitary.

Lexis/Nexis was operated as a completely separate line of business because there was no meaningful functional integration, centralization of management, or economies of scale between Mead's unitary paper business and Lexis/Nexis.

Furthermore, there were no synergies between Mead and Lexis/Nexis; they were not [7] interdependent, and they did not share valuable information or the fruits of their respective labors. They did not benefit from the research conducted by the other; there was no sharing of customer lists; there was no sharing of the benefits that come from joint expenditures or purchases; they did not join forces and do more cheaply that which either could do acting on its own; they did not sell to each other at concessionary prices; and there were no joint undertakings to share administrative functions.

The management of Lexis/Nexis did not regularly communicate with the management of Mead. Each business maintained control over its day-to-day operations. Lexis/Nexis was operated separately and independently of Mead, which is not surprising given the disparate nature of their businesses.

Mead and Lexis/Nexis did their own internal accounting. Each had its own in-house legal department. Each hired its own outside lawyers if needed. Each did its own billing, collected its own receivables, and paid its own payables.

Lexis/Nexis and Mead kept separate bank accounts. Lexis/Nexis' funds were not used for either the long-term or short-term financing of Mead. Lexis/Nexis' assets were not directly pledged as collateral for any loan obtained by Mead, and Mead's assets were not directly pledged as collateral for any loan obtained by Lexis/Nexis.

Lexis/Nexis and Mead had decentralized human resources departments, which were independent of each other. Lexis/Nexis and Mead did not share human resource functions. For example, potential employees of Lexis/Nexis applied for employment directly to Lexis/Nexis; potential employees of Mead applied for employment directly to Mead. The power to hire, fire, or layoff, with the exception of a few of the highest level officers, was vested independently in Lexis/Nexis and Mead.

Lexis/Nexis trained its own people and Mead trained its own people. This separate and independent training reflected the dissimilar nature of their businesses.

Lexis/Nexis and Mead did not share transportation vehicles; more generally, they did not share transportation functions.

Lexis/Nexis and Mead did not have shared mail functions. Each business processed its own mail.

Lexis/Nexis and Mead each had their own internal public relations/communications department. These internal departments were self contained and operated independently of [8] the other.

Lexis/Nexis and Mead conducted their own advertising and marketing on a stand-alone basis. There was no integrated sales force. Lexis/Nexis advertising and marketing personnel had no institutional relationship with Mead advertising and marketing personnel.

Lexis/Nexis and Mead did not jointly purchase theft supplies and did not coordinate their buying efforts.

Lexis/Nexis and Mead did not share common facilities. Lexis/Nexis had its own offices in the suburbs many miles

from Mead's location in downtown Dayton. Lexis/Nexis had a cafeteria, an indoor gym, and outside athletic facilities; Mead had none of these.

Lexis/Nexis and Mead conducted no common manufacturing; they did not conduct or share research and development facilities or activities.

Mead and Lexis/Nexis each had an internal audit program, which provided for constant evaluation of the adequacy of, and adherence to, management's established policies and procedures.

Mead did not approve purchase contracts by Lexis/Nexis in its day-to-day business, did not co-sign contracts, did not purchase inventory for Lexis/Nexis, did not assist Lexis/Nexis in purchasing, advertising, conducting its research or development, warehousing, or filling or training personnel. There was no shared credit cards, promotional displays, or joint advertising campaigns. There was no meaningful sharing of goodwill or of common expertise. Lexis/Nexis did not contribute to Mead's paper business nor was Mead's paper business dependent on Lexis/Nexis.

In short, Lexis/Nexis and Mead were managed independently of one another; did their own budgeting, marketing, advertising, sales, accounting, and tax; did their own hiring, training, and firing; had their own legal counsel; had their own human resource departments; had their own public relations and communications departments; did their own research; did not share facilities; and did not engage in joint purchasing or selling. Lexis/Nexis and Mead did not engage in common activities, generated no synergies between each other, were not interdependent, did not share valuable information or the fruits of their

labors, and were conducted essentially as if they were owned by different persons.

The decentralized operation of Mead and Lexis/Nexis is understandable, given that the former was in the paper business and the latter was in electronic publishing. Lexis/Nexis had [9] nothing to do with Mead's paper business and Mead had nothing to with Lexis/Nexis's electronic publishing. Lexis/Nexis was sold as a stand-alone, on-going business, with a workforce in place.

Based on the above facts and applying the governing principles of state tax policy, my opinion is that Mead and Lexis/Nexis were separate businesses. Lexis/Nexis did not contribute to Mead's unitary paper business nor was Mead's unitary paper business dependent on Lexis/Nexis. Accordingly, I conclude that from a policy perspective, Lexis/Nexis is not part of Mead's unitary paper business so that for that reason no nexus exists between Illinois and the gain on the liquidation of Mead's ownership of Lexis/Nexis to justify the Department's apportionment of the gain.[8]

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[8] Even if Lexis/Nexis were part of Mead's unitary paper business, the liquidation gain would not be apportionable in any state that followed the Uniform Division of Income for Tax Purposes Act (UDITPA). The liquidation gain would not satisfy a requirement consistent with UDITPA's that in order to be apportioned, the income must arise "from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA, Sec. 1(a). The gain would be allocated under UDITPA's detailed rules. UDITPA, Sections 4-8. Presumably, the income is allocated because apportionment of liquidation gain would be inconsistent with the policies underlying UDITPA's use of formulary apportionment for business income. See the discussion in Part V below.

### B. Policy considerations regarding whether Mead had activities in Illinois regarding the liquidation of Lexis/Nexis that would justify treating the income as apportionable income

Normative principles of state tax policy would justify Illinois' treating the liquidation income as apportionable income if Mead's activities in the State were responsible for the sale. Under those circumstances, Illinois might view those activities independently of Mead's business operations in Illinois and treat the income from such activities as generating the liquidation gain. Under this approach, it would be improper to apply Mead's normal apportionment formula to the gain because that formula was calculated using the factors of Mead's Illinois business operations. However, as a policy matter, Illinois could design an appropriate formula to deal with this special case.

It is unnecessary to explore the design of that special formula because as applied to the facts of this case, normative principles of taxation would not justify Illinois apportioning any part of the liquidation gain.

[10] Mead's activities in Illinois had nothing to do with the decision to sell Lexis/Nexis. Mead's Illinois activities were all related to its Illinois business operations and had nothing to do with the liquidation of Lexis/Nexis.

The decision to liquidate Lexis/Nexis was made at Mead's head office and commercial headquarters in Ohio. None of Mead's head office personnel were based in Illinois. None of the activities that took place in Illinois were directly related to Mead's liquidation of Lexis/Nexis, nor was any

person working for Mead in Illinois involved in the decision to sell Lexis/Nexis.

In short, Illinois has no connection with any activity that led to the liquidation income. Accordingly, such income should not be apportioned by Illinois.

## V. Illinois' apportioning the gain realized by Mead on the liquidation of Lexis/Nexis would be inconsistent with the policies underlying formulary apportionment

The policy considerations underlying the Illinois three-factor apportionment formula, require that Mead's income from the liquidation of Lexis/Nexis not be apportioned to Illinois. The State's apportionment formula, like any similar formula, works acceptably well for dealing with the everyday business profits of Mead. Those profits can be viewed as being generated by the payroll, sales, and property of the business. Illinois' share of each respective factor can be viewed as helping to generate the ordinary profits of the business. Consequently, there is a matching between the income and the factors that helped generate that income.

In this case, no Illinois personnel or property or, for that matter, any other Illinois activities helped generate the liquidation income that the Department is now seeking to tax. No one in Illinois had anything to do with Mead's decision to sell Lexis/Nexis.

In addition, Lexis/Nexis served no operational function with respect to Mead's paper business in Illinois. Applying the apportionment formula to the liquidation income would give Illinois a slice of that income. Yet from a policy

perspective, nothing occurred in the State that would justify that conclusion.

There is yet another related policy reason why the liquidation proceeds should not be apportioned to Illinois. The Illinois apportionment formula, like all apportionment formulas, is hardly scientific. There is no economic theory or model upon which the formula is based and no principle that dictates, for example, that the receipts factor should be double weighted rather than evenly weighted or even given some other weighting.

[11] One of the reasons, however, that makes the formula workable and acceptable is that as long as it is applied over time to the everyday, recurring business profits, any errors or slippages in the formula are likely to wash out. That is, in one year the formula may overstate the contribution of Illinois labor to generating Mead's everyday profits and understate the contribution of Illinois property. In another year, the formula may overstate the contribution of Illinois property and understate the contribution of Illinois labor. Over time, however, these differences are likely to offset one another. In other words, from the perspective of the taxpayer doing business in the State, the formula produces an acceptable result over time, a kind of "rough justice."

This assumption that imperfections, defects, and weaknesses in the formula will be offset over time cannot hold true with respect to the gain on the liquidation of Lexis/Nexis by Mead. The liquidation gain cannot be viewed as part of Mead's everyday, recurring business profits and thus any defects in the Illinois formula will not be self correcting. The obvious overreaching of the Illinois formula that would result if applied to the liquidation gain

is substantial and cannot be ignored on the grounds that in the future the formula will self correct by underreaching income to which Illinois would otherwise have a legitimate claim.

## VI. From a tax policy perspective, a Departmental regulation violates the separation of powers doctrine

You asked me to evaluate from a tax policy perspective whether a regulation[9] issued by the Department violates the separation of powers doctrine. That doctrine requires that any regulation issued by an executive agency not be in conflict with, or in any manner be inconsistent with, a statute enacted by the legislative branch. If a regulation conflicts with, or is inconsistent with, a statute, an executive agency exceeds its powers, which are limited to implementing and interpreting the law as passed by the legislature.

The regulation you asked me to evaluate interprets the sales factor in the apportionment formula described above.[10] Illinois law, as enacted by the Legislature, provides that the term sales means "all gross receipts of the taxpayer not allocated . . ."[11] The regulation at issue, however, provides that in certain instances amounts less than the gross receipts – and sometimes no amounts at all – are to be included in the sales factor.[12]

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[9] 86 Ill. Adm Code Sec. 100.3380(b)(5)(B)

[10] See Part III.

[11] 35 ILCS 5/1501(a)(21).

[12] 86 Ill. Adm Code Sec. 100.3380(b)(5)(B).

[12] This regulation is an example of an executive agency violating the separation of powers doctrine. Rightly or wrongly, the Legislature defined "sales" to include *all* gross receipts of income that is apportioned. The word "all" is unambiguous and leaves no latitude for an executive agency to cherry pick which of a corporation's gross receipts it will include in the sales factor.

"All" means "all." If the Department wishes the statute were to read differently, its approach should not be to usurp the judgment of the Legislature by violating the separation of powers doctrine but rather to request that the law be changed. Any change must come from the Legislature, however, for it is not within the powers of an executive agency to substitute its views for that of the legislative branch.

## VII. Conclusion

Lexis/Nexis was in electronic publishing, having nothing to do with Mead's paper business. Mead had no expertise in electronic publishing nor did it attempt to manage Lexis/Nexis. Mead did not purchase Lexis/Nexis in order to park its short-term working capital. Lexis/Nexis was a completely separate business having nothing to do with Mead's unitary paper business. There was no functional integration, centralization of management, or economies of scale between Lexis/Nexis and Mead. Moreover, the sale of Lexis/Nexis resulted in the total liquidation and cessation of a separate line of business, Mead's electronic publishing business. Finally, no one in Illinois had anything to do with the decision to sell Lexis/Nexis.

From a policy perspective, Illinois can apportion the liquidation income only if there is some connection between such

income and Mead's activities in Illinois. A rational relationship must exist between the income Illinois seeks to tax and the activities of Mead in Illinois. I have applied normative principles of taxation to the relationship between Mead, the liquidation income, and Illinois. In my opinion, no connection exists between Illinois and the liquidation gain that justifies Illinois apportioning the gain. Furthermore, apportioning the liquidation gain would be inconsistent with the principles underlying formulary apportionment.

Finally, the Department's regulation that attempts to cherry pick a corporation's gross receipts and include only some, but not all, gross receipts in the sales factor violates the separation of powers doctrine by usurping the judgement of the Legislature.

# APPENDIX I

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**Part I**
**Report of Economic Considerations Concerning the Right of Illinois to Tax as Business Income to Be Apportioned the $1.2 Billion Gain Realized by the Mead Corporation on its Sale of Mead Data Central to Reed Elsevier**

**Part II**
**Report of Economic and Tax Policy Considerations Concerning the Illinois Department of Revenue's Decision to Modify The Sales Factor's Treatment of Sales by The Mead Corporation of Short-term Working Capital Instruments**

**Expert Report of**
**Ferdinand P. Schoettle, LL.D., Ph.D.**

**[CURRICULUM VITAE INTENTIONALLY OMITTED]**

**October 2001**

## Preliminary Matters

*1. Retention*

I have been retained by counsel for The Mead Corporation ("Mead") as an expert economist with substantial training in matters of state and local taxation to offer my opinion as an economist concerning the right of Illinois to tax as business income to be apportioned the $1.2 billion gain realized by Mead on its sale on December 2, 1994, of Mead Data Central to Reed Elsevier. Also, I have been asked to render an opinion as an economist on the decision by the Illinois Department of Revenue to modify the sales factor's treatment of sales by Mead of short-term working capital instruments.

Mead Data Central normally has been referred to as "Lexis-Nexis." Mead Data Central will be so denominated in the balance of this report.

*2. Qualifications*

I am Ferdinand P. Schoettle Professor of Law at the University of Minnesota Law School, Minneapolis, MN. My training is in law and in economics. I graduated in 1960 from Harvard Law School *magna cum laude*. In 1983 I was awarded my Ph.D. in economics, also from Harvard. In addition to teaching, I have worked as a tax policy expert both at the U.S. Treasury and at the Brookings Institution and have consulted on tax policy matters for the International Monetary Fund and for the United States General Accounting Office. I have taught, among other places, at the University of Minnesota, at Harvard University, at Uppsala University, Uppsala, Sweden, and at William Mitchell University, St. Paul, Minnesota.

I have been accepted and have testified as an expert-economist witness in a variety of cases involving economic and tax policy issues. A copy of my curriculum vitae is attached.

*3. Materials*

In addition to those sources cited in the body of the report, I have relied in preparing this report upon the following:

A. The Mead Corporation Annual Reports and various other documents filed with the SEC;

B. Articles from newspapers, from magazines, and from professional journals concerning Mead and Lexis-Nexis;

C. Tax returns filed by Mead between 1988 and 1994;

D. Upon material in my forthcoming book, *State and Local Taxation and Finance* (Lexis Publishing forthcoming 2002);

E. Upon a variety of public finance texts and materials from the World Trade Organization, the U.S. Treasury Department and the Organization for Economic Cooperation and Development;

F. From online research into various sources including the Harvard Business School, the Technical Association of the Pulp and Paper Industry and its serial publications, including the *TAPPI Journal*, and into the *Pulp & Paper Journal* and fact book; and

G. From conversations with users of Lexis-Nexis and with individuals familiar with Mead, with the forest products industry or with the pulp-and-paper business.

## Part I
## Report of Economic Considerations Concerning the Right of Illinois to Tax as Business Income to Be Apportioned the $1.2 Billion Gain Realized by Mead on its Sale of Lexis-Nexis to Reed Elsevier

### A. The Business-Income Issues

I have been asked to familiarize myself with the operating relationships between Mead and Lexis-Nexis so that I may give my opinion on various economic relationships between Mead and Lexis-Nexis. All of these economic relationships concern whether the income realized on the sale of Lexis-Nexis to Reed Elsevier should be allocated or should be apportioned and taxed to Mead as "business income." In general, as shall be detailed below, Mead is a vertically integrated forest products, pulp-and-paper company. Lexis-Nexis is an information services company.

I have been asked to form an opinion as an expert economist on the following economic tests which speak to the relationship between Mead and Lexis-Nexis.

– Was the relationship between Mead and Lexis-Nexis characterized by functional integration, by centralization of management, or by economies of scale?

– Did I find in my investigations of the operating relationship between Mead and Lexis-Nexis any transactions between Mead and Lexis-Nexis that were not undertaken at arm's length; a management role by Mead of Lexis-Nexis which was grounded in its own operational expertise and operational strategy; or that Mead and Lexis-Nexis were engaged in the same line of business?

– Was Lexis-Nexis a discrete business enterprise? Was the relationship between Mead and Lexis-Nexis characterized by any sort of symbiotic relationship by which Mead and Lexis-Nexis contributed to the support of each other in ways not investigated by the above inquiries concerning the relationships of functional integration, centralization of management, and economies of scale?

– Did Mead's acquisition, management and disposition of Lexis-Nexis closely relate from an economic standpoint to Mead's regular trade or whole process of operating its business?

## The Business of Mead

Mead was incorporated in 1930 under the laws of the state of Ohio as the outgrowth of a paper manufacturing business founded in 1846. In 1996 Mead officially celebrated its 150th year as a player, indeed a major player, in the forest products, pulp-and-paper business. Mead's principal executive offices and principal executives are at Mead World Headquarters in Dayton, Ohio.

Mead is a vertically integrated forest products, pulp-and-paper company. It owns forests from which it takes timber to produce paper. Mead's principal businesses during the years under investigation, that is 1994 and the years prior to that, can be divided into two parts. First Mead produced pulp-and-paper forest products. These forest products are sold mostly, almost exclusively, to producers such as the printing industry and to producers for packaging. Second, Mead operated a consumer office products business. This business both produced paper-based school and home-office supplies and distributed paper, packaging and business supplies made by other manufacturers. The

product of the office-products business mostly was purchased by final users not for incorporation into a product. In addition, in 1968 Mead acquired Lexis-Nexis, an information services company. The acquisition was an investment in a business that had no connection with the forest products pulp-and-paper business.

**Forest Products The Pulp-and-Paper Business**

*a. The Supply of Pulp for Production of Paper, Packaging and Paperboard*

Timberlands

Mead obtains most of its wood requirements from private contractors or suppliers and from Company owned timberlands. The annual wood requirement for Mead's wholly-owned operations is approximately 8,000,000 tons, of which approximately 16% is obtained from timberlands owned or leased by Mead.

As of December 31, 1993, Mead owned or controlled approximately 1,337,000 acres of timberlands in the United States. Approximately 106,000 acres of land are controlled by Mead under long-term agreements which expire at different times through 2027.

Forest Products Affiliates Northwood Forest Industries Ltd. ("Northwood"), which is owned 50% by Mead and 50% by Noranda Forest Inc. ("Noranda"), manufactures bleached softwood kraft pulp at its 1,600 ton-per-day mill in Prince George, British Columbia. Mead has a long-term contract with Northwood pursuant to which Mead is entitled to purchase such of Northwood's pulp production as it may require. The principal markets for its pulp are in the midwestern United States, western Europe and Japan.

Lumber and plywood products are also produced at Northwood's three sawmills and its plywood plant in British Columbia. Northwood has the annual capacity to produce over one billion board feet of lumber and 175 million square feet of plywood (3/8-inch basis). Northwood's solid wood products' operations provide about 670,000 tons (ODT) of wood chips or 70% of the fiber requirements for the Noranda pulp mill. A wood preserving operation also treats lumber and custom treats plywood from other sources.

Northwood Panelboard Company, a partnership owned 50% by Mead and 50% by Noranda and located in Bemidji, Minnesota, has the annual capacity to produce approximately 340 million square feet of oriented structural board (3/8-inch basis).

The Mead Pulp Sales division sells market pulp manufactured by Northwood and by a non-affiliate, Aracruz Celulose S.A. The division maintains one sales office and is represented by affiliates and independent agents in all major pulp-consuming areas of the world. The principal market areas for pulp are in North America, western Europe and Japan. All of the wood products produced by Northwood and Northwood Panelboard Company are sold through a subsidiary of Noranda primarily in North America with approximately 20% sold to export markets.

*b. Production by the Mead Paper Divisions – Including the Fine Paper Division, Publishing Paper Division, Gilbert Paper Division, and Specialty Paper Division – of Paper, Paperboard, Coated Paperboard, and Packaging Materials*

Paper Production

Mead Fine Paper division produces both coated and uncoated papers for business, printing and specialty uses. The division is also a leading producer of carbonless paper. Mead's Fine Paper division manufactures cut-size copier paper, uncoated and coated papers for commercial printing, form bond and carbonless paper and papers for conversion by others into business forms, and other uncoated papers for conversion by others into such products as greeting cards and bank checks

The Publishing Paper division provides book and magazine publishers, catalog printers and commercial printers with more than 500,000 tons of medium-weight coated paper each year. The division has developed a full line of recycled book and glossy grades in response to customer interest. The Fine Paper division sells papers manufactured by both divisions nationwide, both on a direct basis to printers and converters and through paper merchants, including merchants owned by Mead. Additionally, Escanaba Paper Company, a wholly-owned subsidiary, sells its output to the Publishing Paper division of Mead, which resells the paper directly to publishers and printers. The pulp mills adjacent to the paper mills of these divisions and the pulp mill owned by Noranda produce virtually all of the pulp required for use in these paper mills.

Mead's Gilbert division manufactures cotton content and premium sulfite paper and premium recycled papers,

including bond, banknote, texts and cover, and technical and specialty papers, and sells these products principally through paper merchants, including merchants owned by Mead.

Mead's Specialty Paper division manufactures and sells, primarily through its own sales force, decorative laminating papers. This division also manufactures absorbent, filter, fire resistant, synthetic fiber and other specialty papers. The division's principal customers include manufacturers that serve the building materials, automotive and furniture industries.

The Gilbert Paper division produces high-quality communications papers, including cotton-content bonds, and specialty text and cover papers. Gilbert Paper produces recycled grades.

Packaging and Paperboard Production

The Mead Packaging division designs and produces multiple packaging and packaging systems primarily for the beverage take-home market. The division operates through a network of subsidiaries, affiliates and licensees in the United States, Canada, Europe, Japan, the Far East and Pacific Rim, Mexico, and Latin America. Demand for most beverage packaging is seasonal with inventories being built from November to March for the peak soft drink and beer sales of April through October.

Mead Coated Board, Inc., a wholly-owned subsidiary of Mead, operates a coated paperboard mill near Phenix City, Alabama, and two sawmills in Cottonton, Alabama and Greenville, Georgia, and owns various timberlands in Alabama and Georgia. The subsidiary is engaged primarily

in the manufacture of coated natural kraft products used by the beverage packaging industry and by manufacturers of folding cartons for soaps, food products, hardware and apparel. The entire output of the Phenix City mill is sold by Mead Coated Board, Inc. to the Mead Coated Board division. The division sells approximately 50% of the mill output to the Mead Packaging division. The remainder is sold to a wide range of domestic and foreign carton converters. The division's customers are most concerned about physical strength properties of the paperboard and its quality for reprographics. Mead started up a new CNK(R) paperboard facility adjacent to the Phenix City mill in late 1990, and has constructed additional sheeting facilities in foreign countries to handle a portion of the increased capacity. In 1993, the division commenced operations at new facilities at the Phenix City mill designed to enable the division to meet beverage packaging customer demand for post-consumer recycled content.

The Mead Containerboard division sells standard and special purpose corrugated shipping containers manufactured at eight converting plants located in the Midwestern and Southeastern regions of the United States from raw materials received from outside sources and from the division's Stevenson, Alabama corrugating medium mill. The division also sells corrugating medium from the Stevenson mill to unaffiliated manufacturers of containers.

International Pulp and Paper Sales and Operations

Outside of the United States and Canada, Mead and its affiliates operate a paperboard sheeting facility and are engaged in the manufacture of multiple systems and

folding carton packaging in Europe, Asia and Latin America. Mead also has sales subsidiaries, affiliates, agents or distributors in a number of countries in Europe, Asia, Australia and Latin America.

### Production and Distribution of School and Office Products

The Mead School and Office Products division manufactures and distributes a line of school supplies (including filler paper, wirebound notebooks, portfolios and looseleaf binders) as well as a line of office supply products (including envelopes, filing supplies and vinyl folders and binders). The division's products are distributed primarily through mass market retailers, office supply superstores and warehouse clubs. The school supply business is highly seasonal with inventories beginning to be built in the winter and spring for shipment in late spring and summer, while the home and office products portion of the business is generally less seasonal in nature. Manufacturing and distribution is done from seven United States plants/distribution centers, and a small manufacturing facility operated in Nuevo Laredo, Mexico.

Zellerbach, Mead's distribution operation, is a national distribution business which distributes a full line of printing papers, industrial supplies and packaging materials and equipment. These products are distributed through a network of wholesale locations and printer-supply retail outlets. The business units carry inventory or order products against sales orders, depending upon the product and service requirements. Zellerbach distributes not only products of Mead, but also those of several hundred other manufacturers. In the distribution of paper and

other products, competing merchants frequently distribute products of the same supplier.

## Lexis-Nexis

Lexis-Nexis markets electronic information services worldwide to corporations, financial institutions, news media, governments and the legal, medical and accounting professions. Principal services include Lexis, a computer-assisted legal research service, and Nexis, a computer-assisted news, financial, marketing and general information retrieval service. Lexis-Nexis's services are distributed to subscribers via subscribers' own computer equipment and custom terminals supplied by Lexis-Nexis.

On May 16, 1994 Mead announced its intention to sell Lexis-Nexis. Mead retained Salomon Brothers to find a buyer. On December 2, 1994 Mead sold Lexis-Nexis to Reed Elsevier for approximately $1.5 billion.

The main reason for the sale, according to those who analyzed the sale at the time and as confirmed by my investigations, was that Mead's capabilities did not include the operation of a computer-based information company like Lexis-Nexis. Because of the visibility of Lexis-Nexis's Lexis and Nexis services and because of the time between the announcement of the desire to sell and the sale itself, many analysts had an opportunity to opine about the reasons for the sale.

Organizational Dynamics reported:

> Despite Data Central's high growth and profitability, it represents only about 12 percent of Mead's total annual revenues. As one analyst put it, 'The demands for information today go beyond

> what a company like Mead can do with the business.' To keep up would divert too many resources from its core businesses - paper, pulp, and other forest products. Carl Long & Mary Vickers-Koch, *Using Core Capabilities to Create Competitive Advantage, Organizational Dynamics,* June 22, 1995.

As *Searcher* reported Mead was not the first to find that owning an information business required an expertise and the ability to make well informed decisions:

> Last of the Amateur Owners
>
> "With the sale of Mead Data Central to Reed Elsevier, content publishers have achieved dominance. No longer will non-information industry companies own or control major search services." [Sales by other owners are here detailed], *Searcher,* Vol. 2, No. 9, November 1994.

The *Dayton Daily News* (Mead is headquartered in Dayton, Ohio) reported an interview with Mead Chairman and CEO Steven C. Mason concerning the decision to sell Lexis-Nexis:

> But while many companies are trying to get on the information highway, Mason is taking Mead back to where it's been. It makes perfect sense to Mason. He believes Mead is more talented at the forest products business.
>
> 'We all have certain talents. We all have certain liabilities. I think we've all a choice to make,' Mason said.
>
> 'Do you maximize your talents, or do you try to overcome your disabilities? My strong view is you maximize your talents and what you can do well.

> It's the same when you think about a Business. You Maximize Your Talents.'
>
> *CEO at Mead Says Decision to Refocus Fits in with Streamlining, Dayton Daily News,* Sunday, May 22, 1994.

A review of the operations of Lexis-Nexis for the few years preceding the sale reveal a host of business problems of Lexis-Nexis to which Mead, the parent company, brought no expertise or guidance. Criticisms of Lexis-Nexis began to surface in 1989, or so. Business problems for Lexis-Nexis included using the Freedom of Information Act to obtain records, the copyright law of cyberspace as it related to the use of West Publishing Company's page numbers, pricing, and technical issues concerning search engines and information organization.

Barbara Quint described the sort of company that might fit well with Lexis-Nexis as follows:

> Just off the top of my head, I suppose the candidates to purchase MDC would come from one of two categories: content-based concerns like publishers or other search services or tool-based enterprises like computer or communications companies.
>
> * * *
>
> Content-heavy companies with lots of print publications moving further and further into the arena of electronic publishing might find MDC an attractive option. Smart publishers should realize by now that one of the key characteristics of the electronic consumer is indifference to sources.
>
> * * *

> Tool-dominant firms like computer or communications companies should appreciate the overnight access to masses of data the acquisition of MDC could give them.
>
> * * *
>
> Either way, the new Mead purchaser should expect to put substantial investment into the service to re-engineer it for the 21st century.
>
> Barbara Quint, *Is Online Ready for Primetime? Speculations on Who Will Acquire Mead Data Central Inc., Information Today,* June, 1994.

**B. The Business-Income Issues and My Opinions**

I have familiarized myself with the business operations of Mead in order to form an opinion about the operating relationships between Mead and Lexis-Nexis.

My opinion is based both on my own investigation of the relationship between Mead and Lexis-Nexis and upon the relevant literature, such as those opinions expressed above, about Mead's inability to "run" Lexis-Nexis. Both the experts who analyzed the relationship between Mead and Lexis-Nexis and the operating personnel seem to agree on the nature of the relationship between Mead and Lexis-Nexis.

As to the operating personnel, after the decision to sell Lexis-Nexis was announced, Lexis-Nexis president Rodney Everhart was queried about the contribution of Mead to Lexis-Nexis. According to President Everhart:

> "Mead Corporation has been a good parent for the last 25 years. They have nurtured and protected us, but they are not in our business. Technology in

> our field is accelerating. We have greater needs for more technology, content, and funding." *Information Industry Mega-sales: Mead Data Central, Ziff-Davis, et Al; Information Services and Data Base Companies for Sale, Searcher,* July, 1994

As to the relationship between Mead and Lexis-Nexis, based on my investigations I concluded that operational integration between Mead and Lexis-Nexis was virtually zero. Mead kept Lexis-Nexis as a separate business, an investment in a very different business than its own. That separateness was the reason Mead sold Lexis-Nexis. Mead had neither publishing nor computer expertise nor any other line function which it could integrate with Lexis-Nexis. Given these conditions, Lexis-Nexis was truly a "stand alone" company.

*My opinions concerning the questions asked of me are as follows.*

– Was the relationship between Mead and Lexis-Nexis characterized by functional integration, by centralization of management, or by economies of scale?

In my opinion as an economist the relationship between Mead and Lexis-Nexis was not characterized by functional integration, by centralization of management, or by economies of scale. To the contrary there was a complete absence of functional integration and any economy of scale. Nor was there centralization of management. The legal status of Lexis-Nexis varied from time to time between subsidiary and division. At no time was the management of Mead's primary forest products and pulp-and-paper business active in managing Lexis-Nexis.

– Did I find in my investigations of the operating relationship between Mead and Lexis-Nexis any transactions between Mead and Lexis-Nexis that were not undertaken at arm's length; a management role by Mead of Lexis-Nexis which was grounded in its own operational expertise and operational strategy; or that Mead and Lexis-Nexis were engaged in the same line of business?

In my investigations as an economist I found no transactions between Mead and Lexis-Nexis that were not undertaken at arms length. Indeed, there seem to have been no transactions of note between Mead and Lexis-Nexis. I found that Mead exercised no management role with respect to Lexis-Nexis that was grounded in Mead's own operational expertise and operational strategy. Lexis-Nexis's information services were too far removed from the forest products, pulp-and-paper business for Mead's expertise in the latter to apply to the former.

– Was Lexis-Nexis a discrete business enterprise? Was the relationship between Mead and Lexis-Nexis characterized by any sort of symbiotic relationship by which Mead and Lexis-Nexis contributed to the support of each other in ways not investigated by the above inquiries concerning the relationships of functional integration, centralization of management, and economies of scale?

In my opinion as an economist, Mead and Lexis-Nexis had no symbiotic relationship by which Mead and Lexis-Nexis contributed to the support of each other. The Lexis-Nexis information services business was too different from Mead's forest products, pulp-and-paper business to offer any sort of symbiotic relationship and support for the forest products, pulp-and-paper business.

– Did Mead's acquisition, management and disposition of Lexis-Nexis closely relate from an economic standpoint to Mead's regular trade or whole process of operating its business?

In my opinion as an economist, the management and disposition of Lexis-Nexis did not closely relate from an economic standpoint to Mead's regular trade or whole process of operating its business. The sale bore little relationship to the needs of the forest products, pulp-and-paper business but came about because Lexis-Nexis was too different a business from the forest products, pulp-and-paper business, and too much in need of some expertise and assistance for Mead to comfortably continue to own Lexis-Nexis.

## C. Tax Policy and Economic Considerations Governing Illinois Income Taxation of The Mead Company on the Gain from the Sale of Lexis-Nexis

### *1. Residency and Source – the Two Grounds for Taxing Income*

Tax policy and economics often go hand in hand. This is particularly true when considering broader problems such as who can tax particular items of income. From the point of view of both policy and economics there are two factual bases on which to tax income. First, a state may ground its right to tax on the residency or domicile of the taxpayer. The relationship is between the state and the taxpayer that the state seeks to tax, not the taxpayer's income. Because of this relationship with the taxpayer a headquarters state may tax world-wide income. To keep things fair the state should grant a credit for foreign taxes. Second, a

state may ground its right to tax on its being the source of the income. The relationship upon which the state relies is between the income that the state seeks to tax and the state.

About these two principles, those of residence of the taxpayer and source of income as a basis for taxation, there is both theoretical and practical agreement. Reports from the United States Treasury, from the Paris-based Organization for Economic Cooperation and Development and from the European Community embrace and explain these two principals.[1] The U.S. Supreme Court and the Internal Revenue Code follow these principals in assigning the tax base of a multi jurisdictional taxpayer. A general rule incorporating these important premises might read as follows:

> A state may tax residents and domiciliaries on all income wherever earned but should grant appropriate credits for taxes paid to foreign jurisdiction. In addition, a state may tax all income sourced in the taxing jurisdiction whether earned by residents or nonresidents

## 2. *Residence-based Taxation*

As to residence-based taxation, the state of Mead's corporate headquarters, Ohio, has the sort of relationship with

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[1] European Economic Community, *Report of the Committee of Independent Experts on Company Taxation* (1992) (Ruding Committee); Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, *Taxing Profits in a Global Economy – Domestic and International Issues* (Paris 1991); United States Treasury Department, *Integration of the Individual and Corporate Tax Systems – Taxing Business Income Once* (March, 1992).

Mead that supports taxing Mead on the basis of its domicile and headquarters.

*3. Source-of-income based taxation*

As to taxation by nondomiciliary states of the $1.2 billion gain to Mead from the sale of Lexis-Nexis, I have found no ground for asserting that this income was business income to be apportioned to Illinois as part of Mead's business operations. From the vantage point of economics and tax policy, for a nondomiciliary state such as Illinois to tax income which is not sourced in the state constitutes a discrimination.

*4. The Discriminatory Effects of Taxing Income of Nonresident Taxpayers Not Earned in the State*

A state income tax on income of a nonresident which the nonresident has not earned in the state creates a discrimination. If a nonresident who does business in a state must pay taxes not only on income earned in the state but also on income not earned in the state, the nonresident has a higher effective tax rate than a resident and has been discriminated against.

According to my analysis, Mead should pay to Illinois a tax on income it has earned in Illinois. To pay a tax on income not earned in Illinois as a price of doing business in Illinois is to suffer a higher marginal tax rate on income earned in Illinois than the rate applied to other taxpayers, a discrimination.

Stanford economist Dr. Charles McLure accounts for the discrimination of an Illinois tax on Mead's gain from selling Lexis-Nexis in a different way than I do. I focus on

the marginal tax rate. Dr. McLure views the tax as a tax on the factors employed in the state. Dr. McLure details how attempting to tax income not earned in a state as a price of doing business in a state constitutes a discrimination against the factors which the taxpayer has employed in the state to earn income.[2] Dr. McLure writes, for example, concerning the taxation by a state of dividends earned abroad by a nonresident domestic multinational:

> In other words a domestic multinational receiving dividends from abroad would pay a higher effective rate of tax on its economic activities in the taxing state than would an identical firm receiving no such dividends. Discrimination (against in-state payroll, property, and sales) is strongest against those domestic firms that have the most profitable foreign operations and repatriate a substantial portion of their foreign-source income (and thus have it available for domestic investment). Besides being patently unfair, such a policy does not seem very sensible from the point of view of the taxing state.[3]

Dr. McLure's conclusions about what constitutes discrimination apply to any tax by Illinois on Mead's gain from selling Lexis-Nexis.

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[2] Charles E. Mclure, Jr, *Economic Perspectives on State Taxation of Multi Jurisdictional Corporations* (Tax Analysts 1986); *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander, Nat'l Tax Jour.* pp. 341-48 (September 1986); *State Taxation of Foreign-Source Dividends: Starting from First Principles*, 86 *TNT* 108-76 (June 2, 1986).

[3] Charles E. McLure, Jr., *State Taxation of Foreign-Source Dividends: Starting from First Principles* and sources cited therein, *Tax Notes*, March 10, 1986, pp. 975-989, 86 *State Tax Notes* 108-76 (Lexis June 2, 1986).

A tax by Illinois on an apportioned part Mead's gain from the sale of Lexis-Nexis would be a discriminatory tax cost made possible only because Mead is an out-of-state, non-domiciliary corporation with income earned in states other than Illinois, income which Illinois by normal standards of tax policy and economics should not tax.

## Part II
## Report of Economic and Tax Policy Considerations Concerning the Illinois Department of Revenue's Decision to Modify The Sales Factor's Treatment of Sales by Mead of Short-term Working Capital Instruments

I have been asked to give an opinion as an economist and tax policy expert on the application of the regulations of the Illinois Department of Revenue which seem counter to the words of the Illinois statutes. First, the Illinois statutes provide that sales for use in the three-factor formula include total sales:

> (3) Sales factor.
>
> (A) The sales factor is a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. 35 ILCS 5/304

As noted by Prentiss Willson in *Recent State Corporate Income and Franchise Tax Developments,* 491 *PLE/Tax* 9 (March-April 2001):

> Under UDITPA §15, the sales factor of the three-factor apportionment formula is defined as a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period,

> and the denominator of which is the total sales of the taxpayer everywhere during the tax period. Section 1 of UDITPA defines sales as "all gross receipts of the taxpayer" other than those related to items of nonbusiness income specifically allocable to a particular state. A plain reading of the UDITPA and the MTC's interpretive regulations reveals that the total gross receipts from the sale of intangible assets, including short-term financial instruments, must be included in the denominator of the sales factor.

Second, the Illinois Department of Revenue has modified the statute by regulations. Regulation 86 Ill. Adm. Code Section 100.3380(c)(6) provides:

> c) Sales factor. The following special rules are established in respect to the sales factor in IITA Section 304(a)(3):
>
> * * *
>
> 6) In the case of sales of business intangibles (including, by means of example, without limitation, patents, copyrights, bonds, stocks and other securities), gross receipts shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor.
>
> Example: In 1990, Corporation A, a calendar year taxpayer, sells stock with an adjusted basis of $98,000,000 for $100,000,000, realizing a federal net capital gain of $2,000,000. Only the net capital gain of $2,000,000 is reflected in A's sales factor for the taxable year ending December 31, 1990.

From a tax policy prospective, this is a major change that should be analyzed carefully and be politically approved

before being made. Illinois is a financial center with many sales of bonds, stocks and other securities. Changing the treatment in the apportionment formula to be accorded sales of bonds, stocks and other securities could have a major impact on the tax liability of various taxpayers and accompanying effects on the Illinois economy.

I have not done sufficient economic analysis to report to the Court what effect the change in the sales factor sought by the Illinois Department of Revenue might have on the economy of Illinois. I can, however, report that economists have done many studies on the effects of the sales factor. Analysis of such effects can be complex. "Obvious" conclusions reached without expert economic analysis may be incorrect. For instance, consider the conclusions reached by James K. Smith in his recent article, *Guide to State Corporate Income Tax Apportionment – Part I,* 2000 *STT* 239-28 (November 20, 2000). The author noted:

> The long-term impact of a change to a state's apportionment formula is more difficult to predict because it depends on a number of factors. In addition to the composition of the state's corporate taxpayers, the long-term impact to the state also depends on how the state's corporations react to the change and how other states react. A state is most likely to boost long-term tax revenues if other states do not change their apportionment formulas in response and, as a result, corporations move their property and payroll into the state making the change. On the other hand, a state is less likely to boost long-term tax revenues when other states respond by making similar changes to their apportionment formulas and, as a result, corporations decide not to increase property and payroll investment in the state making the initial change.

Economists have mostly focused their analyses of the sales factor on the issue of the effects of adopting a single-factor sales formula. See, for instance, Austin Goolsbee, Edward Maydew and Michael S. Schadewald, *What Would Happen if Wisconsin Adopted A Single-Factor Sales Apportionment Formula?,* 2000 *STT* 49-23 (March 13, 2000); Kelly Edmiston, *Optimal Factor Weights in State Corporate Income Tax Apportionment Formulas,* 1999 *STT* 108-27 (June 7, 1999); Allen Maury and Laird Graiser, *New Mexico's Corporate Income Apportionment Formula – Effects of Double-weighting the Sales Factor,* 93 *STN* 21-23 (February 2, 1993); Bharat N. Anand and Richard Sansing in *The Weighting Game: Formula Apportionment as an Instrument of Public Policy,* 53 National Tax Journal 183 (2000).

The exact issue on which the Illinois Department of Revenue has acted without legislative approval has been a major political battle ground. The Multistate Tax Commission proposed a change to the Uniform Division of Income for Tax Purposes' regulations that is similar in spirit to that announced by the Illinois Department of Revenue. A hearing on the proposed regulation was held Thursday, July 8, 1999. No further action has been taken. As Prentiss Willson, *supra,* notes:

> The MTC's proposed regulation provides compelling evidence that despite the apparent clarity of the statutes and the regulations, the issue of whether gross receipts, rather than net profits, from the sale of intangibles must be included in the sales factor is quite controversial. The controversies are playing out in the administrative arena and in the courts.

In my opinion, such a change in a major accounting variable should be made by the legislature, not by an unelected administrative agency.

Ferdinand P. Schoettle
October 2001